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REVENUE PROPOSALS CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

APRIL 12 AND 13, 1989

Serial 101-32

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REVENUE PROPOSALS CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

WEDNESDAY, APRIL 12, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearings follow:]

FOR IMMEDIATE RELEASE
FRIDAY, MARCH 17, 1989

PRESS RELEASE #8
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PUBLIC HEARINGS ON REVENUE PROPOSALS CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold two days of public hearings to review the revenue proposals contained in President Bush's Budget for Fiscal Year 1990. The hearings will be held on Wednesday, April 12, and Thursday, April 13, 1989, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. each day.

In announcing these hearings, Chairman Rostenkowski stated: "The President's Fiscal Year 1990 Budget contains significant revenue proposals, some of which increase and some of which lose revenue. While this Committee already has received testimony on the budget from the primary Administration policymakers, it is important that the public be given an opportunity to express their views on the specific revenue proposals contained in the President's budget."

SCOPE OF THESE HEARINGS:

President Bush's Budget for Fiscal Year 1990, submitted to the Congress on February 9, 1989, contains the following revenue proposals with respect to which the Committee requests public testimony:

1) Capital gains tax rate reduction for individuals;

2) Itemized deduction for adoption expenses;

3) Tax credit for research expenditures;

4) Allocation and apportionment of research expenses;

5) Tax credits for oil and gas exploration and tertiary recovery;

6) Modification of oil and gas percentage depletion rules;

7) Modification of the tax preference for intangible drilling and development costs in the alternative minimum tax;

8) Extension of the Medicare payroll tax to all State and local government employees;

9) Repeal of the tax reduction trigger for Airport and Airway Trust Fund excise taxes;

10) Permanent extension of the 3-percent telephone excise tax;

11) User fee/tax for U.S. Travel and Tourism Administration; and

12) Miscellaneous user fees classified as budget receipts.

A description of each revenue proposal mentioned in this press release is contained in a Joint Committee on Taxation pamphlet entitled, "Summary of Revenue Provisions in President Bush's Fiscal Year 1990 Budget Proposal" (JCS 6-89), published March 3, 1989.

Due to hearings either scheduled or completed by the Subcommittee on Human Resources and the Subcommittee on Trade, these full Committee hearings will not address the President's proposals regarding (1) child care credits, (2) the elimination of the Superfund petroleum tax differential, and (3) the Customs Service user fee. Also, the Committee will not receive testimony at this time on enterprise zone proposals since the President's budget does not present any specific legislative details. In addition, these hearings will not address the President's outlay proposals within the Committee's jurisdiction. It is anticipated that various subcommittees of the Committee will provide an opportunity for the public to present views on such outlay proposals.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721)] no later than Friday, March 31, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721)].

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearings. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are requested to briefly summarize their written statements. The full statement will be included in the printed record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business Friday, May 5, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the last day of the hearings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman Rostenkowski. The committee will come to order.

For the next 2 days, the Committee on Ways and Means is scheduled to receive testimony from public witnesses on the various revenue proposals contained in President Bush's budget for fiscal year 1990.

Earlier this year, the committee heard testimony from the primary administration policymakers on the budget proposals. President Bush's budget contains several significant revenue proposals, some of which raise revenue and some of which lose revenue.

While the committee has had an opportunity to hear the administration's view on these proposals, it is equally important for us to hear the views of public witnesses, who are in a position to comment on their effectiveness and appropriateness.

We cannot forget, however, that the most critical issue facing this committee and the Congress this year is the budget deficit. It is imperative that the Congress and the administration move ahead now to take responsible and credible action.

Congressional and administration representatives have been meeting over the last few weeks in an effort to forge a bipartisan agreement on how to proceed this year. Without such a bipartisan agreement, the committee cannot and will not be in a position to take effective action on the budget reconciliation legislation.

Many of the proposals that we will be discussing in the next 2 days deal with important issues that demand the committee's attention. The record we create by these hearings will be important for any action the committee may take in the future.

Today the committee will hear testimony on proposals in the area of oil and gas, the research and development credit, the allocation of research and development expenses, extension of the telephone excise tax, repeal of the airport trust fund tax reduction trigger, and adoption expenses.

Tomorrow these hearings will continue with the focus on issues of the tax treatment of capital gains and the extension of Medicare payroll tax to all State and local government employees.

I am pleased to welcome members that will join us in the panel, but before I introduce them, the Chair recognizes Mr. Archer.

Mr. Archer. Mr. Chairman, thank you. I also welcome our witnesses today, because all of us are looking forward to hearing their thoughts on the revenue proposals contained in the President's budget.

Their analyses of the various proposals will be important to us, especially as you have said, since the budget negotiators appear to be moving closer to an agreement. This means there is an increasing likelihood that our committee will be involved in a deficit reduction package.

The Ways and Means Committee has had several hearings already this year on budget related issues, with particular emphasis on the near- and long-term effects of budget deficits on the U.S. economy. In other words, we received the big picture views from numerous academicians, economists, and Government policymakers.

Now, it is time for us to hear from those in the private sector. Those, some may say, who live and work in the real world who would be directly affected by whatever legislation this committee produces in the way of deficit reduction, and today, of course, the focus is on the President's recommendations.

It will come as no surprise to this committee that as a long-time proponent of measures to ensure our national energy security, I am anxious to hear the views of the energy community on the President's energy security tax proposals. Although the President's energy proposals do not go as far as I have proposed in my bill, H.R. 664, I am very encouraged that they represent a significant move in the right direction.

Last, but certainly not least, I look forward to hearing from witnesses who, in this stage of the debate, can give us their views on how the President's capital gains tax reduction proposals will affect capital formation, capital savings and job creation.

My strong views on this important subject are reflected by the fact that I have introduced three bills of my own in this Congress which address various aspects of the capital gains issue—H.R. 719, H.R. 1599, and H.R. 1601. In my opinion, this is a vital issue which must be addressed in legislation we might develop in the context of deficit reduction later this year.

Thank you, Mr. Chairman, for calling these hearings and giving all of us on the committee the benefit of hearing from the witnesses who will be before us today and tomorrow.

Chairman ROSTENKOWSKI. Thank you, Mr. Archer.

I am pleased at this time to welcome Richard Rahn from the Chamber of Commerce and Robert McIntyre from the Citizens for Tax Justice, who will address themselves to several proposals contained in the President's budget.

Mr. Rahn.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. RAHN. Mr. Chairman, thank you very much.

I am Richard Rahn, vice president and chief economist of the U.S. Chamber of Commerce. On behalf of the chamber, I thank you for the opportunity to present testimony with regard to the tax proposals that President Bush has included in his fiscal year 1990 budget.

The chamber supports a fair and flexible freeze approach to budgeting that is substantially similar to the framework that President Bush has adopted in his budget.

The fair and flexible freeze contains three components. Leave Social Security alone. Pay interest on the national debt without assuming any reduction in interest rates. Increase the total amount of remaining Federal spending no greater than the rate of inflation. Spending for some programs may increase more than inflation and new programs may be created, but spending on other existing programs must increase less than the rate of inflation or be reduced to compensate.

If the economy achieves no better than the postwar average rate of real economic growth, 3.3 percent, the fair and flexible freeze will balance the budget by fiscal year 1993. Even if the national economy falls short of the postwar average growth by as much as 12 percent and grows on the average of only 2.9 percent annual real rate, the fair and flexible freeze will balance the budget no later than fiscal year 1994.

President Bush and many congressional leaders have clearly stated they are opposed to tax increases. They are willing, however, to endorse reasonable user fees. In this context, there is a great deal of confusion about what the difference is between a tax and a user fee.

The user fee is an amount charged by government for value received when it provides a good or service to the recipient. When a user fee is charged, there is a close nexus between the fee and the good or service provided. A true user fee is analogous to a price charged by a private provider of goods and services and to the extent the fee exceeds the marginal cost of the good or service, it becomes nothing more than a tax.

For example, the charges for passengers to ride on Amtrak are user fees. Charges for Government publications are user fees. Coast Guard charges to boaters for rescue services or marine weather information are user fees. Aviation taxes used to fund air traffic control and build airports are user fees. Gasoline taxes that are used to build highways are user fees, but gasoline taxes that are used for purposes other than providing highway service are taxes.

We support real user fees, but not tax increases.

Capital gains. At a 33-percent rate, the top capital gains rate is the highest that it has been since 1978. The United States now taxes long-term capital gains at a higher rate than nearly all of its major Asian and European competitors.

The current level of capital gains taxation discriminates against capital income, discourages venture capital formation, impedes job creation, and hinders the U.S. international competitiveness by raising the cost of capital relative to that of its competitors.

If history is any indication, a reduction in the capital gains tax rate to the level that President Bush has proposed will raise revenue by stimulating growth and by dramatically increasing capital gains realizations.

The President has been joined in his call for a reduced level of capital gains by numerous Members of Congress from both political parties.

Opponents of a rate reduction want us to believe that the debate is about tax breaks for the wealthy. At the heart, the debate surrounding the tax treatment of capital gains is between those who wish to punish success versus those who wish to create opportunity.

Only a desire to punish can explain why anyone would advocate a capital gains tax rate that loses revenue, discourages economic growth, reduces competitiveness, costs jobs, and unfairly taxes people on inflationary gains. The tax policies advocated by these people are the same spiteful tax policies pursued in the late 1960's and 1970's. America cannot afford so short a memory. Those policies brought about economic decline and stagnation.

President Bush has proposed that we embrace opportunity and reject the arguments of those who wish to punish success and limit our horizons. The President's call for a return to a fair and constructive level of tax on capital gains deserves our support.

The administration's capital gains proposal is constructive, but certain modifications are economically appropriate. A capital gains differential should apply to individual and corporate capital gains. The Bush proposal would needlessly limit the benefits of a capital gains differential. All of the sound arguments that apply to reinstating the capital gains differential apply to corporate capital gains as well. In addition, we believe that a differential should apply to all capital assets, including timber and depreciable property. Most of the bills introduced in Congress would apply the differential to corporate as well as individual capital gains and would cover most productive capital assets.

The chamber supports modifying the administration's proposal to include these changes. It is also concerned that long holding periods may have a very detrimental effect on capital market liquidity as it did in the 1930's.

A high capital gains tax rate reduces venture capital and new business formation. This, in turn, slows the creation of jobs. Historical evidence reveals a strong correlation between the availability of venture capital and changes in the level of capital gains taxation.

The most unfair aspect of the present method of taxing capital gains is that it ignores the fact that much of the gain from the sale of a capital asset is often attributable to inflation.

I guess my time is up, Mr. Chairman——

Chairman ROSTENKOWSKI. No; it is not.

Mr. RAHN. OK. When gains are due in part or entirely to inflation, a capital gains tax serves to confiscate existing wealth generated from past income that has already been taxed at least once. The taxation of inflationary gain is not only economically counterproductive, but also unfair. It is completely indefensible for the Government to create inflation, and then tax the imaginary gain that results from inflation.

IRS data show that capital gains are actually spread quite evenly throughout recurring income groups. In fact, in 1985 people with recurring annual incomes below $20,000 received a larger proportion of capital gains than those earning over $200,000. Moreover, at least half of all capital gains went to people earning a recurring annual income of less than $60,000.

The 25-percent R&D tax credit has been successful in stimulating corporate spending on R&D operations since its enactment in 1981. Unfortunately, the 25-percent credit only applied for R&D expenditures through 1985. Although the Tax Reform Act of 1986 extended the R&D tax credit through 1988 at a 20-percent rate, and the credit was extended until the end of this year in the 1988 tax bill, the uncertainty surrounding the future of the provision has caused less R&D investment to take place.

To maximize the benefits from the R&D tax credit for both businesses and society as a whole, the credit must be made permanent. The uncertainty surrounding the future existence of the credit will lead businesses to reduce their commitment to long-term R&D projects. And in turn, will reduce the social benefits to R&D spending to all Americans.

Because the foreign tax credit is limited to 34 percent of a company's foreign source taxable income, there is a need to define the source of taxable income for that purpose. Treasury Regulation Section 1.861-8 requires that indirect expenses be apportioned to the sources of income.

Presumably, if this defining process is properly carried out, that which is U.S. source income will be taxed in the United States, that which is foreign source income will be taxed in the foreign nation, and the U.S. tax on foreign source income will be eligible for relief provided by the foreign tax credit mechanism.

The allocation of indirect expenses to foreign source income, without a corresponding foreign deduction, has the inherent effect of taxing the same earnings twice if a corporation runs up against its foreign tax credit limitation. The result, of course, defeats the very purpose of the foreign tax credit, which is to prevent double taxation.

The solution is to provide that R&D expenditures incurred in the United States are to be 100-percent allocated to U.S. source income. As an interim step toward that goal, 67 percent of R&D expenses should be allocated to the United States.

Mr. Chairman, my entire statement is available for the record, and I appreciate the opportunity to be with you today.

[The statement of Mr. Rahn follows:]

TESTIMONY
ON
THE PRESIDENT'S TAX PROPOSALS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
FOR THE
U.S. CHAMBER OF COMMERCE
BY
Richard W. Rahn
ON
April 12, 1989

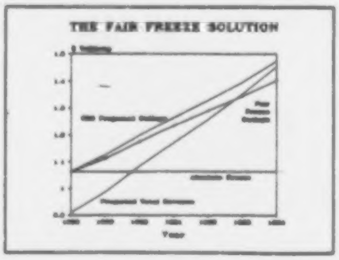
I am Richard Rahn, Vice President and Chief Economist of the U. S. Chamber of Commerce. On behalf of the Chamber, I thank you for the opportunity to present testimony with respect to the tax proposals that President Bush has included in his Fiscal Year (FY) 1990 budget. I will focus on five particular issues. First, the flexible freeze approach to the federal budget; second, the difference between taxes and user fees; third, proposals to reinstate the capital gains differential; fourth, the research and development tax credit, and fifth, the research and development allocation issue.

A FAIR AND FLEXIBLE FREEZE

The Chamber supports a fair and flexible freeze approach to budgeting that is substantially similar to the framework that President Bush adopted in his budget. The fair and flexible freeze consists of three components:

- o Leave Social Security alone. Provide all benefits to existing beneficiaries and new entrants that are called for under current law, which include upward adjustment in payments to compensate for inflation.
- o Pay interest on the national debt without assuming any reduction in interest rates. Interest rates may fall as the deficit declines, but the plan does not depend on their falling.
- o Increase the total amount of all remaining federal spending no greater than the rate of inflation. This permits Congress to set priorities. Spending for some programs may increase more than inflation, and new programs may be created. But spending on other existing programs must increase less than inflation or be reduced to compensate.

If the economy achieves no better than the postwar average rate of real economic growth (3.3 percent annually), the fair and flexible freeze will balance the budget by FY 1993. Even if the national economy falls short of the postwar average rate of growth by as much as 12 percent and grows on average at only a 2.9 percent annual real rate, the fair and flexible freeze will still balance the budget no later than FY 1994.



The key to reducing the federal budget deficit is to restrain spending growth while maintaining strong economic growth. Revenues will continue to grow by 7 to 8 percent annually as long as the economy grows. If spending increases at the inflation rate, then the deficit will substantially decline.

Perhaps the most anti-growth policy that Congress could pursue would be a tax increase. Accordingly, the Chamber opposes tax increases and recommends that the Congress, in addition to pursuing federal spending restraint and avoiding tax increases, adopt a number of pro-growth policies. Our testimony discusses three specific policy initiatives made by the Bush Administration that would promote economic growth. Before I discuss those specific policy proposals, however, I would like to take a moment to discuss exactly what is and is not a tax increase from the Chamber's perspective.

GEESE AND DUCKS

President Bush and many Congressional leaders have clearly stated that they are opposed to tax increases. They are willing, however, to endorse reasonable user fees. In this context, a great deal of confusion has arisen about the difference between a tax and a user fee. This is, no doubt, partially because it is in the interest of tax increase proponents to blur the distinction.

Office of Management and Budget Director Richard Darman has said that he knows a tax because if it walks like a duck and quacks like a duck then it must be a duck. Presumably, a user fee is more like a goose.

A user fee is an amount charged by the government for value received when it provides a good or service to a recipient. When a user fee is charged, there is a close nexus between the fee and the good or service provided. A true user fee is analogous to a price charged by a private provider of goods and services, and to the extent the fee exceeds the marginal cost of the good or service it becomes nothing more than a tax.

For example, the charges for passengers to ride on Amtrak are user fees. Charges for government publications are user fees. Coast Guard charges to boaters for rescue services or marine weather information are user fees. Aviation "taxes" used to fund air traffic control and to build airports are user fees. Gasoline taxes that are used to build highways are user fees. But gasoline taxes that are used for purposes other than providing highway services are taxes.

A tax can, of course, be imposed on income, consumption, transactions, services, or other things. When a tax is imposed, there is little or no nexus between the tax and the good or service provided. The benefit, if any, accruing to the taxpayer accrues to the benefit of the general public as well.

Thus, the income tax is a tax because the income taxpayer receives no exclusive or particular benefit for his tax dollar. A cigarette excise tax is a tax because the tobacco user receives no benefit for his tax payment. So-called Internal Revenue Service (IRS) user fees, where the government requires payment of a fee to file a return or make an election (for example, the Subchapter S corporation election fee), are taxes because they are mandatory if a taxpayer is to comply with the tax law.

In my testimony of July 1987 before this Committee, I described about $20 billion of non-tax revenue-raisers that the Chamber either supports or believes deserve serious consideration. These are geese, not ducks, and we once again recommend their consideration, particularly if the revenues are used to fund pro-growth changes in the tax law.

CAPITAL GAINS

At 33 percent, the top capital gains tax rate is the highest that it has been since 1978. The U.S. now taxes long-term capital gains at a higher rate than nearly all of its major Asian and European competitors.

The current level of capital gains taxation discriminates against capital income, discourages venture capital formation, impedes job creation, and hinders the U.S.'s international competitiveness by raising the cost of capital relative to that of its competitors. Lower capital gains rates would stimulate economic growth, promote technological innovation, and create new opportunities. If history is any indication, a reduction in the capital gains tax rate to the level that President Bush has proposed will raise revenue by stimulating economic growth and by dramatically increasing capital gains realizations.

The President has been joined in his call for a reduced level of capital gains taxation by numerous members of Congress from both political parties. Representatives Archer and Crane have both introduced capital gains tax rate reduction bills. Representatives Rhodes, Stangeland, Morrison, and AuCoin have introduced capital gains tax rate reduction bills as well. In the Senate, capital gains tax rate reduction bills have been introduced by Senators Cranston, Kasten, Bumpers, and Boschwitz. Bills to index capital gains have been introduced in both chambers. All of these efforts are commendable and would promote economic growth. They demonstrate the widespread support in Congress for a reduction in capital gains tax rates. (Table I provides a summary of major capital gains bills).

TABLE I

SUMMARY OF CAPITAL GAINS PROPOSALS: Bush - Boschwitz - Cranston - Bumpers - Kasten - Crane - Archer

	Bush	Boschwitz (S.411)	Cranston (S.551)	Bumpers (S.349)	Kasten (S.171)	Crane (H.R.461)	Archer (H.R.1599)
Exclusion	45% after 3 years, except hold 1 yr (1989-1992) hold 2 yrs (1993-1994) hold 3 yrs (1995+)	40% after 1 year 60% after 3 years	10% after 1 year 30% after 3 years 60% after 5 years	25%-4 year holding period, applies only to direct purchases of small business stock ($100 mil. paid in capital)	50% after 1 year	no exclusion 15% flat rate on all capital assets no holding period	50% after 1 year
Long Term Rates							
15% bracket	8.25%	6.0%	6.0%	11.25%	7.5%	15% flat rate regardless of bracket	7.5%
28% bracket	15.00%	11.2%	11.2%	21.00%	14.0%		14.0%
33% bracket	15.00%	13.2%	13.2%	21.00%	14.0%		16.5%
Individuals	YES	YES	YES	YES	YES	YES	YES
Corporations	NO	NO (though corporations pay max. 28%)	YES	YES	YES	YES	YES
Collectibles	NO	YES	NO	NO	NO	YES	YES
Section 1231 Assets (business assets - timber, coal, iron ore, livestock, unharvested crops, depreciable & real property used in trade or business)	NO (except land held by individuals)	YES	YES	NO	YES	YES	YES
Alternative Minimum Tax Applies	NO	YES	YES -- 50% of excluded gain added back in	YES	NO	NO	NO
100% Exclusion	adj. gross income below $20K	NO	adj. gross income below $25K; assets held over 5 years	NO	NO	NO	NO
Indexing	NO	NO	NO	NO	YES, to the extent inflation exceeds 4%	YES	NO

Additional Capital Gains Bills

H.R. 499 - Rhodes
Provides for indexing the basis of certain capital assets to account for inflation and provides for a 15% tax on the net capital gains of corporations and individuals.

H.R. 1601 - Archer
Provides for a maximum long-term capital gains rate of 15% for individuals and corporations.

H.R. 1542 - Stangeland
Provides for a maximum capital gains rate of 15% for long-term capital gains to the extent such gains do not exceed $100,000.

H.R. 1029 - Morrison & AuCoin
Provides for a restoration of the capital gains differential through a 100% exclusion for assets held at least 5 years, 60% for assets held at least 3 years, and 40% for assets held less than 3 years.

H.R. 719 - Archer, H.R. 504 - Rhodes, S. 182 - Heinz, S.664 - Armstrong, H.R. 1242 - Dornan
All provide for indexing the basis of certain capital assets held for more than one year. S. 171 Kasten provides for indexing the basis of certain assets held for more than one year, but only to the extent inflation exceeds 4%.

S. 645 Boschwitz
Provides for the indexing of certain capital assets, and also increases the holding period for capital assets from 1 to 3 years.

Opponents of a rate reduction want us to believe that this debate is about tax breaks for the wealthy. They resort to the politics of envy, and use statistics designed to give the appearance that those who realize capital gains are overwhelmingly wealthy. In fact, most capital gains are realized by people who have recurring incomes in the middle- and lower-income ranges.

This debate is not about rich versus poor. It is about America's economic future. It is about encouraging new opportunities, new business, and new technology. It is about creating jobs and expanding the U.S. tax base. The debate is about the U.S.'s competitive position in the world economy.

At its heart, the debate surrounding the tax treatment of capital gains is between those who wish to punish success and those who wish to create opportunity. Only a desire to punish can explain why anyone would advocate a capital gains tax rate that loses revenue, discourages economic growth, reduces competitiveness, costs jobs, and unfairly taxes people on inflationary gains. The tax policies advocated by these people are the same spiteful tax policies pursued in the late 1960s and 1970s. America cannot afford so short a memory. Those policies brought economic decline and stagnation. President Bush has proposed that we embrace opportunity and reject the arguments of those who wish to punish success and limit our horizons. The President's call for a return to a fair and constructive level of tax on capital gains deserves our support.

The Administration's capital gains proposal is constructive, but certain modifications are economically appropriate. A capital gains differential should apply to individual and corporate capital gains. The Bush proposal would needlessly limit the benefits of a capital gains differential. All of the sound arguments that apply to reinstating the capital gains differential apply to corporate capital gains as well. In addition, we believe that a differential should apply to all capital assets, including timber and depreciable property. Most of the bills introduced in Congress would apply the differential to corporate as well as individual capital gains and would cover most productive capital assets. The Chamber supports modifying the Administration's proposal to include these changes. It is also concerned that long holding periods may have a very detrimental impact on capital market liquidity, as it did in the 1930s.

International Comparison

A recent study conducted by Arthur Anderson & Co. demonstrates that U.S. capital gains tax rates are among the highest in the industrialized world. As Table II shows, Germany, Italy, the Netherlands, Belgium, Hong Kong, Taiwan, South Korea, and Singapore all completely exempt long-term capital gains from taxation. Japan's recent tax reform imposes a maximum federal tax on capital gains of 5 percent. Even the Socialist governments of France and Sweden tax long-term capital gains at 16 percent and 18 percent, respectively.

TABLE II

COMPARISON OF U.S. TAXATION OF INDIVIDUAL CAPITAL GAINS WITH SOME OF OUR EUROPEAN AND ASIAN COMPETITORS

COUNTRIES	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States (A)	33.0%	33.0%	One Year	None
Australia	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (B)	17.51%	17.51%	None	None
France (C)	16%	16%	None	None
Germany (D)	56%	Exempt	Six Months	0.5%
Italy	Exempt	Exempt	None	None
Japan (E)	5%	5%	None	None
Netherlands	Exempt	Exempt	None	0.8%
Sweden	45%	18%	Two Years	0.3%
United Kingdom(F)	40%	40%,indexed	None	None
PACIFIC BASIN				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

*State, provincial and local taxes not included.

(A) The nominal tax rate for long and short-term capital gains is 28 percent. The marginal rate, however, rises to 33 percent for joint returns between $74,850 and $155,370 and for single returns between $44,900 and $93,130 for calendar year 1989.
(B) Canadian residents are allowed an annual capital gains exemption of Canadian $30,000 ($22,998**) subject to a cumulative exemption of up to Canadian $500,000 ($383,300**) in 1990.
(C) Gains from proceeds of up to FF 272,000 ($45,288**) are exempt from taxation in a given taxable year.
(D) The first DM 1,000 ($554**) of short-term capital gains is exempt from tax.
(E) Japan's tax reform plan, which takes effect in 1989, imposes a maximum tax of approximately 5 percent on the sale of securities.
(F) Only gains and losses accrued since 1982 will be taxed; gains since 1982 are indexed.

** Based on exchange rates as of March 31, 1987.

Source: Prepared by Arthur Andersen & Co. for the Securities Association in March, 1987; updated by the American Council for Capital Formation Center for Policy Research, March, 1989.

The level of capital gains taxation is an important element in the cost of capital. The cost of capital in this country is higher than in many of the other industrialized countries. Dr. Yolanda Henderson, an economist with the Boston Federal Reserve Bank, has conducted research showing that elimination of the capital gains differential resulted in a significant rise in the cost of capital in the U.S. John Shoven, chairman of the Economics Department at Stanford University, has calculated that following the 1986 tax act, the cost of capital in the U.S. is 81 percent higher than in the U.K., 63 percent higher than in Japan, and 26 percent higher than in West Germany. Our high cost of capital is one reason why America is facing increasingly stiff economic competition from abroad. If we are to effectively meet the international economic challenge we must restore a fair and intelligent level of taxation for capital gains.

Encouraging Venture Capital

A high capital gains tax rate reduces venture capital and new business formation. This in turn slows the creation of new jobs. Historical evidence reveals a strong correlation between the availability of venture capital and changes in the level of capital gains taxation. One measure of this is the amount of capital raised in securities markets through Initial Public Offerings (IPOs). Table III shows the trend in IPOs over the past two decades. While capital gains rates were rising from 1969 to 1978, the dollars raised through IPOs declined steadily from over $2.6 billion in 1969 to a mere $249 million in 1978. After capital gains tax rates were cut in 1978 (from a top marginal rate of 49% down to 28%) the amount raised through IPOs rose dramatically to $3.2 billion by 1981. Capital gains tax rates were again reduced in 1981 (from 28% down to 20%), and by 1983 the amount raised through IPOs increased to over $12.6 billion.

TABLE III

NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS (IPO's)

Year	Marginal Tax Rate Capital Gains	Number of IPO's	Dollars Raised (in billions)
1969	27.5%	1,026	$ 2.605
1970	32.3	358	.780
1971	38.8	391	1.655
1972	45.5	568	2.724
1973	45.5	100	.330
1974	45.5	15	.051
1975	45.5	15	.265
1976	49.1	34	.234
1977	49.1	40	.153
1978	48.3	45	.249
1979	28.0	81	.506
1980	28.0	237	1.397
1981	23.7	448	3.215
1982	20.0	222	1.446
1983	20.0	884	12.619
1984	20.0	354	3.900
1985	20.0	362	8.600
1986	20.0	719	22.400
1987	28.0	541	24.200
1988	33.0	280	23.400

Explanation: IPO's refer to new capital issued through initial public stock offerings of corporations. This capital flows largely to relatively young rapidly growing companies.

Source: Dealer's Digest, Inc., publishers of GOING PUBLIC: The IPO Reporter

Professors John Freear and William Wetzel Jr. of the University of New Hampshire recently conducted a study of how new technology-based ventures raise equity capital. Their study reveals the critical role of taxable capital gains in start-up companies.

Professors Freear and Wetzel studied financial history data provided by 284 technology-based ventures started in New England between 1975 and 1986. Of these firms, 177 reported raising outside equity financing (from sources other than family and friends). These firms raised $76 million from private individuals, $370 million from venture capital funds, and $122 million through public stock offerings. Some have argued that because tax exempt entities, such as pension funds, endowments, and foundations, and foreign investors provide significant sums of money to professionally managed venture capital funds, capital gains tax rates have little impact on the availability of venture capital. However, the Freear-Wetzel study shows that when total financing per round was under $1 million, private individuals, not venture capital funds, were the primary source of outside equity capital for new technology-based firms. Private individuals invested $33.6 million in 160 rounds of equity financing involving less than $1 million, while venture capital funds invested $27.6 million in 53 rounds under $1 million. Private individuals provided 58 percent of the financing rounds ranging from $250,000 to $500,000 and 84 percent of the financing rounds of less than $250,000 (see Table IV). The study also reveals that private individuals are more willing to invest during the early stages of a new technology-based company than are venture capital funds. Private individuals were more frequently the ones investing more during the seed and start-up stages (see Table V).

Table IV: Financial Rounds of Capital Invested in New Technology-Based Firms

Size of Round	Private Individuals (% of total)		Capital Funds (% of total)		Venture All Other Sources (% of total)		Total	
Less than $250,000	102	(84%)	8	(6%)	12	(10%)	122	(100%)
$250,000- $499,000	43	(58%)	14	(19%)	17	(23%)	74	(100%)
$500,000- $999,000	15	(26%)	31	(55%)	11	(19%)	57	(100%)
Greater than $1,000,000	17	(9%)	120	(63%)	55	(28%)	192	(100%)
Total	177		173		95		445	

Table V: Rounds of Capital Invested in New Technology-Based Firms

Stage of Financing	Private Individuals (% of total)		Venture Capital Funds (% of total)	
Seed	52	(29%)	11	(6%)
Start-up	55	(31%)	38	(22%)
First Stage	29	(16%)	56	(32%)
Second Stage	26	(25%)	46	(27%)
Third Stage	10	(6%)	19	(11%)
Bridge	5	(3%)	3	(2%)
Total	177	(100%)	173	(100%)

Start-up capital is critical for the entrepreneur, whose creativity preserves America's technological edge. The entrepreneur suffers most from the high cost of capital. Established firms have little trouble acquiring capital. By raising the cost of capital, we help to preserve the status quo and aid those who are perfectly content to see fresh competition deprived of necessary capital.

Finally, the capital loss limitation of $3,000 introduces an asymmetry into the taxation of risky ventures that discourages investment in new firms. In effect, the government is saying: heads I win, tails you lose. If we wish to avoid discouraging people from investing in what are often risky start-up ventures, we should permit a larger deduction from income in the event of a capital loss.

Taxation of Inflationary Gain Is Unfair

The most unfair aspect of the present method of taxing capital gains is that it ignores the fact that much of the gain from the sale of a capital asset is often attributable to inflation. When gains are due in part or entirely to inflation, a capital gains tax serves to confiscate existing wealth generated from past income that has already been taxed at least once. The taxation of inflationary gain is not only economically counterproductive but also unfair. It is completely indefensible for the government to create inflation and then tax the imaginary gain that results from inflation.

This is no minor point. For example, if one bought $1,000 of stock invested in the Standard and Poor's 500 Index in 1970, that stock would have sold for $3,571 in 1989. This would have been a capital gain of $2,571. At the current 33% tax rate, the taxpayer pays $848 in tax. However, inflation since 1970 totaled 218%. This means that the taxpayer's real net gain in 1989 dollars was only $391. He was taxed $848 on a real gain of $391. This is an outrageous 217% rate of taxation. These facts demonstrate the compelling need to index capital basis or adjust capital gains tax rates to reduce the unfairness of this tax.

Lower Capital Gains Tax Rates Increase Revenue

The effect on tax revenues of changes in the capital gains tax rate is a major point of contention between proponents and opponents of a rate reduction. Yet the historical evidence and a number of recent academic and government studies indicate that revenues will increase significantly following a rate reduction.

The Department of the Treasury estimates that the Administration's capital gains proposal would increase revenue by $16.1 billion through 1993. This is disputed by the Joint Committee on Taxation, which estimates a $13 billion revenue loss through 1993. But the Joint Committee has been wrong in the past. The Committee estimated that the 1978 rate reduction would cost the government more than $2 billion annually. Yet revenue rose following the 1978 cut. The increase was not simply in the year following the rate cut but continued in successive years. Capital gains tax revenue rose from $9.1 billion in 1978 to $11.7 billion in 1979 and $12.5 billion in 1980. The 1981 rate reduction brought about a similar increase in revenue. Revenue rose from $12.7 billion in 1981 to $24.5 billion in 1985. In 1986, when taxpayers saw the capital gains tax increase coming, tax revenue from capital gains exceeded $45 billion.

Dr. Lawrence Lindsey, formerly of Harvard University, has examined the relationship between tax rates and capital gains. His findings confirm the negative effect of high capital gains taxes on federal revenues and indicate that large revenue gains are likely from a reduction in the capital gains tax rate. Dr. Lindsey based his findings on a review of five of the recent leading academic and government investigations of capital gains taxation. The methodology used in all but one of the studies predicts revenue losses from the 1986 capital gains rate increase. Preliminary data from the IRS show that capital gains realizations dropped significantly in 1987. According to Professor Lindsey's analysis, all but one of the academic and government studies that he reviewed indicate that the revenue maximizing capital gains tax rates range from 9 percent to 21 percent. Based on the findings of the five studies, Dr. Lindsey estimates that a reduction in the capital gains rate to 15 percent would increase revenue by nearly $15 billion over three years.

In 1988 the Department of the Treasury published an updated version of its 1985 study of the revenue effects of capital gains taxation. The original Treasury study stated that "The available statistical evidence shows that the reduction in tax rates on capital gains in the 1978 Act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut, and in the long run either increased or only slightly decreased the annual federal revenue from capital gains taxes." Similar conclusions were drawn regarding the 1981 capital gains rate cut. The update, entitled "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," written by Michael Darby, Robert Gillingham, and John Greenlees extended the sample used in the 1985 study, and corrected several flaws in that earlier study. The update concludes unequivocally that both the 1978 and 1981 capital gains tax changes significantly increased revenue.

Even the 1988 Congressional Budget Office study on the historical effect of a rate change on revenue, often cited by opponents of a rate reduction, found that changes in tax rates on capital gains produced a significant change in behavior on the part of investors. That study concluded that the revenue maximizing rate was probably below the current top rate of 33 percent. The study made four point estimates of the revenue maximizing rate. They were all below the present top rate. Equally important, the study would not rule out, based on the data, that 15 percent was the revenue maximizing rate.

History shows that rate reductions increase revenue. Even if revenue did not increase it seems clear that a revenue neutral tax policy change that encouraged investment and savings, reduced the cost of capital, and increased jobs would be a wise policy change.

All Americans Benefit from Lower Capital Gains Taxes

Few myths are as enduring as the belief that reductions in the capital gains tax rate redistribute the tax burden to the benefit of the wealthy. The experience of the 1980s belies this myth. Reducing the capital gains tax actually increases the progressivity of the tax system by increasing the share of the overall tax burden borne by taxpayers in upper income groups. Statistics from the years following both the 1978 and 1981 capital gains tax cuts show that although taxpayers in all income groups increased their realization of capital gains, those in upper income groups increased their realizations and, therefore, their taxes by a larger amount than those in lower income groups (see Table VI).

Table VI: Increase in Net Long-Term Capital Gains by AGI Class Following a Rate Cut

AGI Class ($000)	% Change 1978-1981	% Change 1981-1984
0 - 25	36.1	78.8
25 - 50	13.3	5.39
50 - 100	69.7	88.4
100 - 500	120.9	76.8
500 & Above	302.7	169.1

Source: IRS Statistics of Income

Though the chart above shows that a capital gains rate cut will result in a dramatic increase in taxes paid by the those in upper income groups, such data tends to overstate the extent to which the truly wealthy realize capital gains. This is because such data include the nonrecurring capital gains of those normally in the middle- and lower-income brackets. These people appear temporarily to be quite wealthy. For example, when a middle-class businessman retires and sells his business, his income that year may increase several hundred thousand dollars. He is "rich" for one year. The next year, however, he is back among the middle class. Realized capital gains tend to be nonrecurring events. Yet, when combined with a taxpayer's other income, those gains appear to be realized predominantly by wealthy people.

IRS data show that capital gains are actually spread quite evenly throughout recurring income groups. In fact, in 1985 people with recurring annual incomes below $20,000 received a larger portion of capital gains than those earning over $200,000. Moreover, at least half of all capital gains went to people earning a recurring annual income of less than $60,000. (see Table VII).

TABLE VII

DISTRIBUTION OF CAPITAL GAINS BY RECURRING INCOME CLASS: 1985

INCOME GROUP (in thousands)	CAPITAL GAINS (in billions)	PERCENT OF ALL GAINS
Under 10	35.30	20.79
10 - 20	8.90	5.24
20 - 30	10.70	6.30
30 - 40	10.10	5.95
40 - 50	11.10	6.54
50 - 75	17.50	10.31
75 - 100	12.50	7.36
100 - 150	13.10	7.71
150 - 200	8.70	5.12
Over 200	41.90	24.68
TOTAL	169.80	100.00

Source: Internal Revenue Service, 1985 Individual Tax Model File, Public Use Sample

What will America gain if we listen to those who wish to retain one of the highest levels of capital gains taxation in the industrialized world? The apparent satisfaction of knowing that we have denied affluent people the benefits of lower taxes. But at the same time, we will deny millions of middle- and lower-income Americans the benefits of a fair level of capital gains taxation. In 1986 nearly 13 million individual income tax returns reported the sale of capital assets. Millions of Americans sell small businesses, their homes, stock, or other assets to support them in their retirement, to buy homes, or to send their children to college. They may appear in the aggregate statistics as wealthy people for one year. But they quickly drop back to the middle- and lower-income brackets in the years that follow.

By pursuing the politics of envy, we not only harm middle- and lower-income Americans, we also imperil America's economic position in the world economy. At a time when most of the industrialized world is cutting capital gains taxes, America is moving in the opposite direction. In an increasingly competitive and global economy, America cannot afford to pursue foolhardy economic policies.

Research & Development (R&D) Tax Credit

The U.S. is and continues to be the largest investor in the free world in terms of absolute size of R&D expenditures. Nonetheless, several considerations show the U.S. effort in less favorable terms.

First, U.S. R&D expenditures are large relative to those of other countries because of the sheer size of the U.S. economy. Measured as a percent of Gross National Product (GNP), our R&D spending is no greater than that of Japan and West Germany, whereas until the late 1970s it was a significantly greater percentage.

Second, a high percentage of U.S. R&D expenditures is spent on defense technology. On the basis of its share of GNP devoted to non-defense R&D, the U.S. has annually trailed Japan and West Germany since the early 1970s.

Third, U.S. technological leadership has been eroding. During the 1970s, the U.S. share of total R&D spending by the five largest R&D spending countries (the U.S., Japan, West Germany, France, and the United Kingdom) declined from two-thirds to one-half. Recent data indicate a further erosion in the relative U.S. R&D position. For example, between 1978 and 1984, the share of R&D in U.S. GNP increased by 0.4 percent of GNP; by comparison, West Germany's R&D spending increased by 0.63 percent of GNP.

Industrial progress depends on the development of new and innovative products and methods. R&D conducted by U.S. businesses is the primary means by which innovation is generated. Scientific developments are transformed into new products and processes that result in increased productivity, improved living standards, and sustained economic growth.

The U.S. experienced a dramatic slowdown in its rate of productivity growth beginning in the mid-1960s, which became progressively worse from 1973-1981. This laggard productivity growth was caused in part by a reduction in the pace of innovation. There is direct evidence supporting this view, particularly the idea that innovation slowed between 1973 and 1981. Based on statistics from the U.S. Patent Office, the number of patents issued to U.S. inventors fell from a high of over 50,000 per year from 1971-1973 to approximately 35,000 per year in the early 1980s.

The reduced innovation, indicated by both the reduction in productivity growth and in patents issued, can be linked to a decline in the growth of R&D spending that took place somewhat earlier. The growth rate of both total U.S. industrial R&D and company funded R&D was sharply lower from 1969-1978 than it was during the prior nine years.

Although it is not possible precisely to identify the impact of R&D on productivity growth, there is a virtual consensus that rapidly growing R&D is a prerequisite of rapid productivity growth. John W. Kendrick, a recognized expert on productivity with the American Enterprise Institute, has emphasized that the slowdown in R&D spending was a major contributor to the decline of productivity growth from the mid-1960s through 1981.

During the early 1980s, there was a resurgence in U.S. industrial R&D spending. From 1982-1984, R&D as a percentage of company sales averaged a little over 3.0 percent compared to 2.3 percent in 1980. Similarly, R&D as a percentage of GNP averaged 1.75 percent during 1982-1984 compared to 1.6 percent in 1980.

The rise in U.S. R&D spending occurred even though the economy experienced a severe recession in 1982. This result is in sharp contrast to past recessionary periods, when the R&D spending levels fell.

Congress recognized the need to restore the U.S. to its previous world economic posture by enacting the 25 percent R&D tax credit in 1981. The 25 percent R&D tax credit was a significant factor behind the increase in U.S. corporate R&D spending during the early 1980s. First, it demonstrated that even in a time of federal budget restraint there was a new commitment by the U.S. government to encourage improved innovation and productivity. In the area of R&D, we have been willing to be pound-wise rather than penny foolish. Second, it provided an important financial incentive for companies to expand their R&D efforts in the U.S.

Based on data from 1984 tax returns, companies that claimed the 25 percent R&D credit increased their 1981 R&D expenses by an average of 48.3 percent over base period spending (i.e., the average amount of R&D spending in the previous three years). The strength of R&D spending in 1982, a deep recession year in which R&D budgets would normally be reduced, is significant evidence that the 25 percent R&D tax credit had a stimulative effect on private R&D efforts.

Observed values for total R&D spending were substantially greater in 1981-1984 than would have been predicted from projections based on current sales and R&D spending in the previous year.

Corporate R&D spending produces benefits to society as a whole beyond the private rewards reaped by the companies involved in the R&D operation. The excess social gains accrue both to consumers and to firms that compete with the companies conducting the R&D. Consumers benefit from lower prices on products as a result of cost-saving innovations and from the availability of new products. Competing firms are able to develop their own applications of innovative technology.

There is a substantial gap between the social and private rates of return for R&D and innovation. As a result, without an incentive such as the R&D tax credit, businesses will spend less in the U.S. on R&D than would be desirable from the perspective of society as a whole.

The most compelling study of social and private returns to innovation was conducted by Professor Edwin Mansfield and his associates at the University of Pennsylvania. This group contacted a large number of diverse businesses and obtained detailed cost and return information for a sample of 17 specific innovations. These innovations were a mixture of new products and new processes. Table VIII is drawn from the study and shows the rates of return that were estimated for the sample of innovations.

The conclusion of the study is that the social rate of return to innovation is very high. The median rate for the group was 56 percent. The median private rate of return was much lower--25 percent. Thus, the median social rate of return was more than twice the private rate of return.

TABLE VIII

SOCIAL AND PRIVATE RATES OF RETURN FROM INVESTMENT IN SEVENTEEN INNOVATIONS

Innovation	Rate of Return (percent) Social	 Private
Primary metals innovation	17	18
Machine tool innovation	83	35
Component for control system	29	7
Construction material	96	9
Drilling material	54	16
Drafting innovation	92	47
Paper innovation	82	42
Thread innovation	307	27
Door control innovation	27	37
Chemical product innovation	71	9
Chemical process innovation	32	25
Chemical process innovation	13	4
Major chemical process innovation	56*	31
Household cleaning device	209	214
Stain remover	116	4
Dishwashing liquid	45	46
Median	56	25

* Based on investment of entire industry

Source: Edwin Mansfield, John Rapoport, Anthony Romeo, Samuel Wagner and George Beardsley, "Social and Private Rates of Return from Industrial Innovation," Quarterly Journal of Economics, 1977, p. 223.

The 25 percent R&D tax credit has been successful in stimulating corporate spending on R&D operations since its enactment in 1981. Unfortunately, the 25 percent credit only applied for R&D expenditures through 1985. Although the Tax Reform Act of 1986 extended the R&D credit through 1988 at a 20 percent rate, and the credit was extended until the end of this year in the 1988 tax bill, the uncertainty surrounding the future of the provision has caused less R&D investment to take place.

To maximize the benefits from the R&D tax credit for both businesses and society as a whole, the credit must be made permanent. The uncertainty surrounding the future existence of the credit will lead to businesses reducing their commitment to long-term R&D projects and, in turn, reduce the social benefits from R&D spending to all Americans.

The social benefits from the R&D tax credit are analogous to an annuity, because additional spending on R&D stimulated by the credit produces returns to society indefinitely. Both the returns and the total additional R&D that generates them compound over time as the R&D credit continues to stimulate new R&D each year.

Any measurement of single-year increases in R&D spending due to the credit not only fails to compute the social returns but also fails to capture a continuous process in which the social gains from a growing additional base of R&D investment are compounding over time.

In a 1985 study, Martin Neil Baily, Robert Z. Lawrence, and Data Resources, Inc. (DRI) concluded that if the 25 percent R&D tax credit were made permanent, it would produce an increase in annual real GNP (in 1985 dollars) of up to $17.7 billion by 1991. The same study shows that when taking into account the increased tax revenue generated in future years by the increase in taxable income produced by the permanent 25 percent credit, the credit may raise federal revenues by up to $4.2 billion by 1991.

By reducing the cost of R&D in the U.S., the R&D credit shifts resources to U.S. based R&D activities and promotes long-term sustained economic growth. The actual increase in R&D spending depends on how businesses respond to a drop in the cost of conducting R&D.

In their analysis, Baily, Lawrence, and DRI estimated corporate response to the R&D credit by multiplying econometric estimates of the price elasticity of R&D by the estimated average value of the effective credit.

The price elasticity of R&D measures the percentage change in the amount of R&D for a given change in the cost of conducting it. For example, if the credit reduces the cost of conducting R&D by 4.0 percent, then a price elasticity of 1.0 would imply an increase in R&D of 4.0 percent. Similarly, a price elasticity of 0.5 would imply a net increase in R&D of 2.0 percent. The price elasticity for R&D spending was estimated to range from 0.3 to 1.0.

The average effect of the credit depends on a number of factors, including current and past R&D spending and tax liabilities and expectations about future R&D spending and profits. Baily, Lawrence, and DRI concluded that up to a 4.0 percent annual increase in R&D spending would result from a permanent 25 percent credit.

Our nation's R&D shortfall cannot be cured in a five- or eight-year period. R&D is inherently long range. In industries such as electronics, product cycles can last three to five years. Each cycle also builds on earlier cycles. In other high technology industries, such as aerospace, product cycles can last 10 to 15 years. In either case, high levels of R&D efforts must be performed every year. American industry is committed to undertaking the necessary efforts. But to enable this, we need sensible and stable policies.

Stability is needed so that industry can plan how its resources will be acquired and how and where they will be employed. This is particularly true with respect to R&D, the fruits of which can only be realized well beyond the time the R&D effort is undertaken.

Allocation of U.S. R&D to Foreign Source Income

Because the foreign tax credit is limited to 34 percent of a company's foreign source taxable income, there is a need to define the source of taxable income for that purpose. Section 861, 862, and 863 of the Internal Revenue code were created to define whether the source of income was within or without the U.S. Treasury Regulation Section 1.861-8 requires that indirect expenses be apportioned to the sources of income. Presumably, if this defining process is properly carried out, that which is U.S. source income will be taxed in the U.S., that which is foreign source income will be taxed in the foreign nation, and the U.S. tax on such foreign source income will be eligible for the relief provided by the foreign tax credit mechanism.

The allocation of indirect expenses to foreign source income, without a corresponding foreign deduction, has the inherent effect of taxing the same earnings twice if a corporation runs up against its foreign tax credit limitation. Under the Tax Reform Act of 1986, it is more probable that multinational corporations will be in that situation. This result, of course, defeats the very purpose of the foreign tax credit, which is to prevent double taxation.

Double taxation results or can result, depending on the particular circumstances, because the U.S. expenses that are allocated under the Section 1.861-8 regulations to foreign source income are not deductible in the foreign jurisdiction because these are the expenses of a U.S. company not a foreign affiliate. Other nations do not allow a deduction of indirect expenses incurred by another entity. Thus, a U.S. taxpayer in effect has its foreign tax credit limitation proportionately reduced to the extent that it conducts U.S. R&D.

A U.S. taxpayer can minimize the penalty imposed by the Section 1.861-8 regulations by moving some of its R&D operations to other nations, so a deduction can be realized and no 861-8 allocation will be required.

An example demonstrating how Section 1.861-8 results in double taxation is shown in Table IX. The example also shows how the regulations result, in effect, in a denial of a deduction in either the U.S. or the foreign country for a portion of U.S.-incurred R&D costs and how this anomaly can be overcome by moving the R&D operations from the U.S.

The example assumes that a U.S. company maintains an operation in foreign Country X, through a foreign subsidiary. The operation in Country X is an exact duplicate of the U.S. operation. Country X's tax laws are identical to U.S. tax laws except that Country X does not have a provision equivalent to Section 1.861.8 and allows a full deduction for all R&D incurred in Country X. In the example, it is assumed that the U.S. requires a 35 percent allocation of U.S. incurred R&D costs to foreign source income. The example also assumes that 100 percent of the income earned in Country X is repatriated.

TABLE IX

HOW SECTION 1.861-8 REGULATIONS CAN RESULT IN DOUBLE TAXATION

Assumed Facts:

1. Company operates in two countries, through subsidiaries, U.S.A. and Country X
2. Factory, sales and support operations in the two countries are exact duplicates. There are no exports.
3. Country X's tax laws are the same as U.S. tax laws except that all R&D expenses incurred in Country X are allocable to Country X source income.

	Model #1 R&D Facility in U.S.A.		Model #2 R&D Facility in Country X	
	U.S.A.	Country X	U.S.A.	Country X
Sales	$1,000	$1,000	$1,000	$1,000
Total Cost, excluding R&D	650	650	650	650
R&D Costs	250			250
Total Costs	900	650	650	900
Income before Tax	100	350	350	100
Tax		119		34
Available for Distribution		231		66
Distribution	231	231	66	66
Gross-Up	119		34	
Taxable Income	450		450	
Tax-Tentative	153		153	
Tax Credit	89		34	
Tax	$ 64		$ 119	
Combined Tax	$ 183		$ 153	

Combined tax rate of two countries

- 40.6% x $450 = combined tax of $183 - Model 1
- 34.0% x $450 = combined tax of $153 - Model 2

Computation on Tax Credit

Foreign Source Income		
Per Country X return	$350	$100
Less assumed Sect.186-1 allocation	88	-0-
	$262	$100
Limitation - 34%	89	34
Foreign tax deemed paid	119	34
Loss of credit	$ 30	$-0-

Using the figures in the example, if the R&D expenses are incurred in the U.S., the effective combined foreign and U.S. tax rate is 40.6 percent, even though the rate in each country is 34 percent. If the R&D operation is conducted in Country X, rather than in the U.S., the effective combined tax rate is 34 percent, equal to the rates imposed in each country.

The regulations also presume that R&D conducted in the U.S. results in the generation of foreign source income and completely ignore the fact that many products manufactured and sold abroad were designed and developed abroad. It makes no sense to require allocation of U.S. R&D expenses to income derived from sale of products abroad that were, in fact, designed abroad.

The solution is to provide that R&D expenses incurred in the U.S. are to be 100 percent allocated to U.S. source income. As an interim step toward that goal, 67 percent of R&D expenses should be allocated to the U.S.

Conclusion

Tax increases are anti-growth and endanger the expansion. The deficit should be reduced through spending restraint within the flexible freeze framework. The Congress should reinstate the capital gains differential to promote economic growth, increase competitiveness and enhance federal revenues. The R&D tax credit should be made permanent and the R&D allocation rules should be reformed to promote research and lay the foundation for continued prosperity.

Chairman **Rostenkowski**. Thank you, Mr. Rahn.
Mr. McIntyre.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. **McIntyre**. Thank you, Mr. Chairman. I appreciate the opportunity to be here.

President Bush has finally put some meat on the bones of his campaign promise of no new taxes. In his budget, as we know, he has proposed higher taxes for most Americans, with very large tax reductions for a select minority.

Taken together, the administration proposals are a frontal assault on this committee's finest achievement, the Tax Reform Act of 1986. We urge the committee to reject the administration's attack on tax reform, and instead to focus on what should be our long-term goal to build on the achievements of the 1986 Tax Act and address the budget deficit in a serious and equitable fashion.

Let me begin by discussing the administration's capital gains plan. As you know, the elimination of the capital gains exclusion was a central element of the 1986 Tax Act. Without it, the top tax rate would have had to have been in excess of 40 percent to be distributionally and fiscally responsible.

Indeed, before tax reform, the richest 1 percent of the people in this country were getting a tax break from capital gains averaging more than $40,000 apiece.

So fairness is one central reason why eliminating the capital gains exclusion was essential to reform. Another, again as we all know, was tax shelters. The capital gains exclusion played a central role in the creation of hundreds of billions of dollars of tax shelters over the decade preceding tax reform.

Now, we have a Tax Code that treats capital gains the same as wages, or interest, or dividends, or other kinds of income. But President Bush wants to change that—to go back to eliminating roughly half the tax on capital gains.

Well, some things everyone can agree on. Certainly we know where the benefits would go—80 percent of them to the top 5 percent of the taxpayers. For 376,000 people at the very top, an average benefit of almost $31,000 each. For most people, the bottom 80 percent, an average benefit of $20.

Why does the Bush administration want to do this? Why does it want to face a revenue loss on its face in excess of $17 billion a year? Well, primarily, the administration says that cutting capital gains taxes will not lose revenues. It says it will raise revenues. For evidence it points to what it says is the historical experience.

But in fact, the historical experience conflicts with the administration's claims. Indeed, when you take out the other factors that were at work in the early 1980's, with the stock market rising, with leveraged buyouts going crazy, which led to more capital gains, with the tax shelter boom, it is very hard to find any effects from previous capital gains cuts in increasing the level of realizations.

Indeed, if you look at Canada, our neighbor to the north, they did not cut their capital gains tax, and yet had the same pattern of realizations that we did, because they benefited from the rising stock market in this country. The result was, they collected more revenue. We did not.

So the historical pattern is not there. In fact, what the administration has predicted, I think, could reasonably be characterized as preposterous—an extra trillion dollars in capital gains over the next several years. In other words, a doubling in realizations if their plan is adopted.

As you know, the Joint Committee on Taxation does not agree with the administration's estimate. Indeed, Joint Tax's own estimate, I think, is very conservative about the revenue loss from this plan.

In summary, we cannot afford it. It is unfair. It would undermine tax reform, and we hope it is not adopted.

Next, let me touch on a few of the other items in the administration's plan.

One of the items, involving the allocation rules under section 861, sounds complicated, but the bottom line on it is pretty straightforward. The administration is proposing huge tax cuts for a handful of multinational companies. Indeed, the proposal might exempt IBM from taxes forever.

The administration proposes to let companies deduct some of the costs of earning foreign income against their domestic profits, and if that occurs, increase their foreign tax credits and perhaps even wipe out their U.S. taxes. We think this is entirely the wrong direction to go on the international area.

Under the administration proposal companies that do a lot of manufacturing abroad will get a tax break. We will help them pay their foreign taxes. That does not make sense to me. We should not be giving incentives for companies that set up manufacturing plants abroad. Our trade problem is bad enough as it is.

So we hope, again, that the administration's proposal on multinational corporations will be rejected by the committee. Indeed, we hope that the committee will move in the other direction and close down some of the existing tax breaks and loopholes that encourage companies to move jobs overseas.

Now let's look at the R&D tax credit. You remember when it was enacted back in 1981. It was going to lead to a big surge in research and development in the country. But there is not any evidence that it has done its job. Indeed, one survey—the only survey actually done of companies—found that any increase in R&D that was accomplished was less than the cost of the tax credit. We might as well give the money to the National Institute of Science.

So we think the time has come after all of these years of experience, to say, "Wait a minute. This is not an efficient Government program. We cannot afford it at a time of tight budgets. Let us move away from it."

Finally, let's examine the administration's proposals in the oil and gas area. My goodness, if there is anything that symbolizes the need for tax reform, it is oil and gas. Yet the administration in its wisdom proposes to weaken the minimum tax on oil and gas producers and to make a number of other changes designed to, it says, give incentives for drilling, but which will certainly lead to significant tax avoidance in the oil and gas area.

Again, we think the amount to be gained from the proposal has to be very small, given that it has been tailored to have a very small revenue cost, but the loss in principle for tax reform is major. We have, I think, begun to try to rekindle public respect for the tax system. We are not done with the job yet, but we have begun it, and to give tax breaks to the oil and gas industry will undermine the good that has been done in the last several years.

So finally, again I want to congratulate the committee on the job it did in the 1986 Tax Reform Act and to say that the job is not done, despite the fact that many loopholes were closed. If the tax system was undoubtedly made fair and more progressive, we still have a tax system that not only fails to pay for the cost of the Government, but that has cut taxes for the very wealthy by about 25 percent over the last decade. We cannot afford that either.

We need to move forward, continuing in the spirit of reform, continuing to rescind some of the misguided tax cuts of the early 1980's, and finally, to deal with the budget deficit so we can stop robbing from our children's future.

Thank you, Mr. Chairman.

[The statement of Mr. McIntyre follows:]

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Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the House Ways & Means Committee
Concerning President Bush's Proposed Tax Cuts For Capital Gains Recipients, Multinational Corporations, Etc.
April 12, 1989

I appreciate the opportunity to appear before the committee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

As part of his budget, President Bush has proposed a number of tax changes. He recommends somewhat higher taxes for most families, but very large tax reductions for a select minority. In this testimony, we will focus on several of the administration's tax cut proposals, specifically those relating to capital gains, research and development, multinational corporations, and oil and gas.

Taken together, these administration proposals amount to a frontal attack on the 1986 Tax Reform Act. Indeed, they seem to reflect a deep-seated antipathy to the idea that the tax code ought to be devoted to raising revenues fairly, rather than to subsidizing certain business activities or particular companies at the expense of others. We urge the Committee to reject the administration's assault on tax reform. Our goal instead should be to build on the achievements of 1986 and thereby to address our nation's budget deficit problem in a serious and equitable manner.

I. Capital Gains

The Tax Reform Act of 1986, which we strongly supported, took long overdue steps to repudiate a tax code that had fostered widespread corporate tax avoidance and allowed half of the wealthiest people in the country to pay a lower share of their incomes in federal taxes than was paid by families at the poverty line. Tax reform wasn't easy. Ultimately, Congress faced the dilemma of how to slash the top income tax rate to less than 30 percent without giving a windfall to the rich. The final reform bill cut the Gordian Knot with two bold swipes: strict limits on using tax-shelter "losses"—the effective tax rate on investments now can't be less than zero—and an end to the special break for capital gains.

Together these two changes form the core of the individual tax reforms in the 1986 tax act. They explain why the final bill was able to reduce the top income tax rate on the highest earners to only 28 percent without being a total boondoggle for the wealthy. Continuing the old loophole (or indexing gains for inflation, as some suggested) would have required a top rate of well over 40 percent to have been fiscally and distributionally neutral.

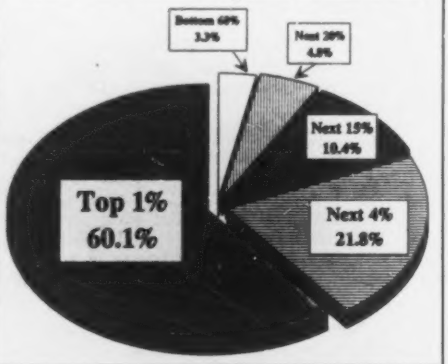
The reason why the treatment of capital gains is so central to tax fairness is that capital gains are the single largest source of income for the very rich. Altogether, profits from selling stocks, bonds, real estate and so forth account for more than a third of the income of people making more than $200,000. The old rule exempting from tax 60 percent of such capital gains saved these top-income folks an average of $41,683 in taxes every year. In contrast, the break was worth less than $20 a year to families earning under $50,000.

Fairness was not the only reason why ending the capital gains exclusion was so important. The old capital gains break provided a key impetus for many economically wasteful tax shelters that diverted resources away from more useful activities. For instance, it fueled a huge wave of excessive office building construction that produced vacancy rates averaging close to 20 percent in most big cities. It diverted resources into unproductive investments such as antiques, llamas and embryonic cattle breeding. A 1981 study by the Agriculture Department found that capital gains treatment for breeding sows actually led farmers to change their breeding practices to a much less efficient approach in order to maximize their tax savings. And as much as one-third of the old tax code was devoted to complicated, largely unsuccessful attempts by lawmakers to restrict abuses of the capital gains break.

As a result of the 1986 Tax Reform Act, profits from selling stocks, bonds, land and so forth now are taxed at the same rates as wages, interest or other kinds of income. But now President Bush wants to reverse course. He proposes to exempt 45 percent of capital gains from tax, with a maximum rate of 15 percent. His plan is the most significant and the most outrageous effort on the part of the opponents of tax reform to undermine the 1986 act. We urge the Committee to reject it.

Who would benefit?

Distribution of the Tax Cuts From the Bush Capital Gains Plan



Many controversial claims have been made on behalf of the President's plan, but nobody disputes one basic fact: cutting capital gains taxes would be a bonanza for the wealthy. According to the Joint Committee on Taxation, 60 percent of the benefits of the Bush plan would go to 376,000 people making more than $200,000 a year. Their average tax savings under the Bush plan would be a staggering $30,820![1] More than 80 percent of the capital gains tax cuts proposed by the administration would go to the best-off five percent of the population.

In contrast, the vast majority of taxpayers have no capital gains at all (other than on their homes, which usually aren't taxed under current law). For the four out of five families earning $50,000 a year or less, the average tax savings from the Bush plan would be only $20.

The administration's claims

On its face, the Bush proposal looks hugely expensive. If there were no change in behavior by wealthy people, the administration itself estimates that its tax-cut plan would add upwards of $17 billion a year to the federal deficit.[2]

But, without doubt, there would be changes in how rich people arrange their affairs. Most obviously, restoring the capital gains loophole would reinvigorate the tax shelter industry. Tax scams designed to convert ordinary taxable income into capital gains would proliferate, adding billions and billions of dollars more to the revenue cost.

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[1] Counting those without capital gains, the average tax cut under the Bush plan for the richest one percent of the population would be $11,630.

[2] The Joint Committee on Taxation estimates annual "static" revenue losses in excess of $21 billion.

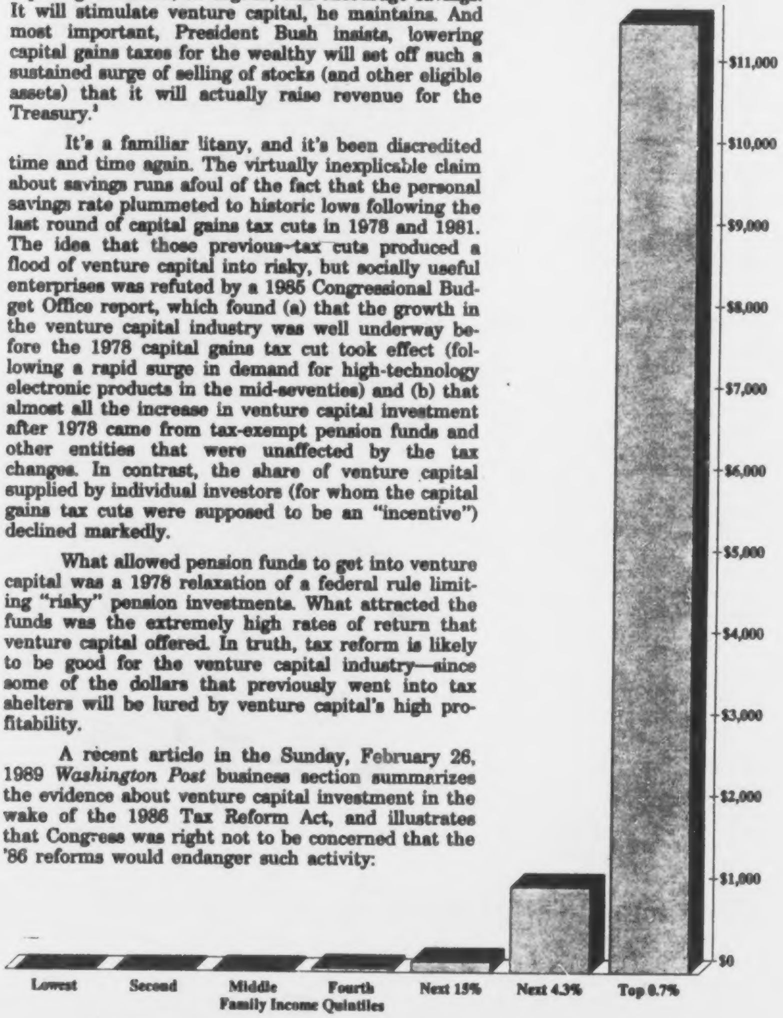
The Bush administration doesn't disagree that tax shelters would be a serious problem—although it lowballs the revenue impact at only $2-3 billion a year. But, don't worry, says the President. Reducing capital gains taxes, he argues, will encourage savings. It will stimulate venture capital, he maintains. And most important, President Bush insists, lowering capital gains taxes for the wealthy will set off such a sustained surge of selling of stocks (and other eligible assets) that it will actually raise revenue for the Treasury.[3]

It's a familiar litany, and it's been discredited time and time again. The virtually inexplicable claim about savings runs afoul of the fact that the personal savings rate plummeted to historic lows following the last round of capital gains tax cuts in 1978 and 1981. The idea that those previous tax cuts produced a flood of venture capital into risky, but socially useful enterprises was refuted by a 1985 Congressional Budget Office report, which found (a) that the growth in the venture capital industry was well underway before the 1978 capital gains tax cut took effect (following a rapid surge in demand for high-technology electronic products in the mid-seventies) and (b) that almost all the increase in venture capital investment after 1978 came from tax-exempt pension funds and other entities that were unaffected by the tax changes. In contrast, the share of venture capital supplied by individual investors (for whom the capital gains tax cuts were supposed to be an "incentive") declined markedly.

What allowed pension funds to get into venture capital was a 1978 relaxation of a federal rule limiting "risky" pension investments. What attracted the funds was the extremely high rates of return that venture capital offered. In truth, tax reform is likely to be good for the venture capital industry—since some of the dollars that previously went into tax shelters will be lured by venture capital's high profitability.

A recent article in the Sunday, February 26, 1989 *Washington Post* business section summarizes the evidence about venture capital investment in the wake of the 1986 Tax Reform Act, and illustrates that Congress was right not to be concerned that the '86 reforms would endanger such activity:

Average Tax Cuts
Under the Bush
Capital Gains Plan



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[3] The administration also suggests that its plan might be seen as a rough-and-ready substitute for indexing capital gains for inflation. To be sure, a theoretical case can be made for indexing, so that only "real" gains are taxed. But to work fairly, such a plan must entail disallowing deductions for the inflationary component of interest payments, as well as taking account of the fact that, unlike other kinds of income, capital gains aren't taxed until assets are sold. Indexing was rejected in 1986 in favor of a lower top tax rate—as noted earlier, if gains were indexed, a rate in excess of 40 percent would be necessary to be fiscally and distributionally neutral. And whatever the merits of inflation indexing, it's not at all what the administration has proposed.

> Few hard statistics have rolled in about the impact of the 1986 capital gains changes, which made gains subject to the same tax rates as wages and salaries. But interviews with some leading denizens of California's Silicon Valley suggest that high-tech ventures have been proliferating lately. Some companies have been forced to offer higher pay for managerial talent, but to critics of Bush's proposal, such a modest impact is about what should be expected.
>
> "Look, suppose someone is really going to hit it big and make, say, $10 million," said Charles McLure, a tax expert at the Hoover Institution who as a Treasury assistant secretary played a key role in formulating the tax-revision proposals that led to the 1986 law. "Does it really matter to them a whole lot whether they're going to keep 72 percent of it [as under current law] or 85 percent of it [as would be true under Bush's plan]? It doesn't seem like it should make any difference." . . .
>
> [Even] the proponents [of the Bush plan] concede . . . that despite the 1986 law, plenty of capital has been available in the past couple of years to help develop and expand young enterprises.
>
> "It's true there hasn't been an abatement of funds into the venture industry," said Norman Fogelsong, general partner at the Mayfield Fund in Menlo Park, Calif. That isn't surprising, Fogelsong, said, because, "most investors in venture capital"—pension funds, university endowments and the like—"have tax-exempt status anyway." . . .
>
> And even among venture capitalists, there are some who see virtually no effect on entrepreneurial activity from the 1986 tax changes.
>
> "I personally don't think many people make a decision to start a company based purely on the economics," said Bill Hambrecht, president of Hambrecht & Quist, a San Francisco venture capital firm. "People who want to start their own companies generally do it because they believe in an idea, and want to prove themselves."
>
> Similar motivations lie behind decisions by managers' to leave big companies for smaller ones, Hambrecht said. Those people "want to be part of something that's just getting off the ground," he said. "I find people are still very attracted by the idea of some ownership in a company, and whether that ownership gets taxed at 25 percent of 33 percent—I haven't met anybody yet where I thought that was the crucial factor."

How much would the Bush plan cost?

One might be tempted to dismiss out of hand the President's final assertion: that cutting capital gain taxes would increase tax collections. After all, the Reagan administration and the Congress only recently concluded that *eliminating* the capital gains loophole would significantly augment revenues. (Perhaps jokingly, Bush officials call the diametrically conflicting estimates "generally consistent.") But because that implausible premise is at the heart of the administration's case for undermining tax reform, it needs to be examined carefully.

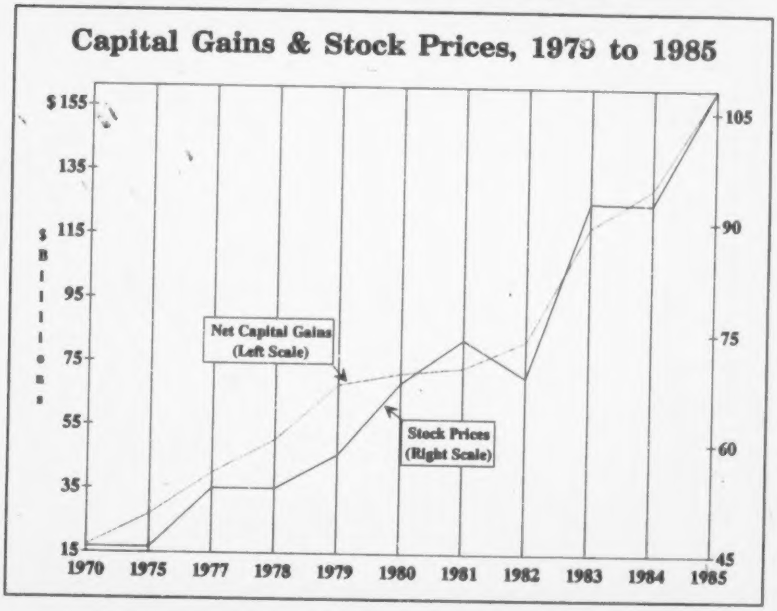
The administration unabashedly predicts that if its plan is adopted, wealthy people will more than double their annual reported capital gains (a necessity to offset the virtual halving of their tax rate). For example, in 1993, according to the administration, capital gains (not counting those ineligible for the proposed tax break) will jump from about $148 billion to $309 billion—an increase of 108 percent! In sum, the administration predicts an increase in capital gains realizations over the next decade exceeding $1 trillion!

Administration Predictions About Capital Gains Realizations
(Eligible Gains Only) ($-billions)

Fiscal Years—	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Current Law:	$129	$140	$148	$154	$158	$162	$165	$169
If Bush Plan Is Adopted:	$284	$298	$309	$261	$301	$243	$332	$350
% Increase:	*+120%*	*+112%*	*+108%*	*+69%*	*+91%*	*+50%*	*+101%*	*+107%*

Is there any reason to expect that to happen? The Joint Committee on Taxation doesn't think so. It estimates that adopting the administration plan would cost a net $25 billion from 1990 to 1994, and $67 billion over the next decade—an estimate that has to be viewed as extremely conservative. But President Bush continues to press his argument. After the top capital gains tax rate was reduced from about 38 percent to 28 percent in 1978 and to 20 percent in 1981, he points out, reported capital gains increased rapidly. Post hoc, ergo propter hoc, he concludes. But look:

From 1977 to 1985, the total value of stocks listed on the New York Stock Exchange grew by more than $800 billion. It's no surprise, therefore, that reported capital gains on corporate stock were about $40 billion higher in 1985 than in 1977. (One can't credit the capital gains tax cuts with the rise in the stock market, by the way. For one thing, an incentive to sell doesn't usually boost prices. For another, stock values almost doubled from 1982 to 1986, a period that saw *no* change in capital gains taxation, and they've gone up by 15 percent more since the end of 1986, after the top capital gains tax rate was *increased* from 20 percent to 28 percent.)



Another big factor boosting reported capital gains was the boom in tax shelters that occurred in the first half of the 1980s. In 1986, the last year before tax reform took effect, almost $100 billion in tax shelter "losses" were reported on individual tax returns (up from less than $10 billion in 1978). There's no doubt that the 1978 and 1981 capital gains tax cuts helped spur that shelter activity, since a primary purpose of the shelters was to allow the rich to transform their regularly-taxed income into lightly-taxed capital gains. But this source of increased capital gains obviously didn't increase government tax collections. Quite the contrary. As Michael Kinsley of *The New Republic* has aptly noted, if the government gave a 50 percent tax cut to people whose name is "Bush," it's quite likely that taxpayers named "Bush" would pay more taxes, since lots of people would change their name. But that hardly would mean the tax break had led to higher total revenues.

Recently, a major source of reported capital gains has been the wave of corporate mergers, hostile takeovers and leveraged buyouts, which have generated close to $600 billion in essentially forced stock sales over the past five years. The involuntary capital gains produced by these deals plainly aren't affected by the tax rate on capital gains.

The historical evidence seems clear. If capital gains taxes had not been reduced in 1978 and 1981, the government would have collected much more in revenues—and the federal budget deficits would have been much lower—than was actually the case. In fact, that's exactly what happened in Canada, where reported capital gains grew in almost exactly the same pattern as in the U.S., despite no change in Canada's tax treatment of capital gains.

II. Multinational Corporations

> "The proposal would permit 67 percent of R&E expenses to be allocated to U.S. source income. The remaining 33 percent would be allocated on the basis of either gross sales or gross income. No limitation would be placed on the allocation to U.S. source income under the gross income method."
>
> U.S. Treasury Dept., *General Explanation of the President's Budget Proposals Affecting Receipts*, February 9, 1989

The administration's recommendation with regard to the international allocation of research costs could hardly be more blandly stated. But the proposal is far from a trivial one. If adopted, it would mean huge tax cuts—even tax exemptions—for a handful of multinational corporations, such as IBM. It would be a giant step in exactly the opposite direction from where our tax policy with regard to multinational companies should be going.

Companies that do business in the United States, whether American or foreign owned, are supposed to pay taxes on the profits that they earn here. Most of the time, we are content to exempt from U.S. tax the income that American corporations earn abroad—in effect, we cede the power to tax those profits to foreign governments. Measuring how much a multinational corporation actually earns in the United States, however, has proved to be a daunting task. Over the years, lawyers for multinational corporations have figured out lots of ingenious ways to minimize their clients' taxable U.S. profits. A perennially favorite technique is to try to deduct some of the costs of earning foreign income against U.S. income. Current law lets corporations get away with a lot of this, and the administration wants to let them get away with more.

One of the most contentious issues in this area involves corporate research (R&E) expenses. It's a familiar pattern for American-based multinational corporations to perform extensive R&E here in the United States to help support an international network of manufacturing and sales. Tax experts generally agree that the most accurate way to divide the costs of such R&E between foreign and domestic earnings is on the basis of sales: if only half of a company's sales are in the United States, then only half of its R&E costs should be used to reduce U.S.-based income for purposes of taxation. Indeed, that's how companies typically allocate their R&E expenses on their books. Were it the requirement for tax purposes as well, multinational companies would pay close to $2 billion a year more in federal income taxes than they do today.

In January 1977, after years of debate, the outgoing Ford Treasury Department issued a regulation agreeing with the experts that, yes, as a general rule, R&E expenses ought to be allocated between U.S. and foreign income based on sales. But the Treasury then proceeded to undercut this victory for common sense with a series of exceptions. The bottom line was that for a company whose sales were divided equally between U.S. and foreign, about 84 percent of R&E costs (instead of 50 percent) could be used to offset U.S. taxable income.

The striking weakness of the 1977 regulations caused howls of protest from tax reformers and academic tax experts. Even so, corporate lobbyists were not satisfied with their already overwhelming victory. They persuaded Congress and the Reagan administration to enact a series of "temporary" laws—in 1981, 1984, 1985, 1986 and 1988—allowing companies to apply an even greater share of their R&E costs—most recently, almost 95 percent in the 50-50 example—to reduce taxable U.S. profits.

For a large company such as IBM, that amounts to a lot of tax avoidance. In its 1987 annual report to its shareholders, IBM says that about one-third of its $8 billion in pretax worldwide profits were earned by its U.S. operations. But for federal income tax purposes, IBM appears to have treated so much of its R&E expenses as U.S.-related that it reported practically no U.S.-source earnings at all. As a consequence, IBM was able to wipe out most of its federal income taxes with foreign tax credits. After taking advantage of some other, relatively minor tax breaks, IBM ended up paying nothing at all in federal income tax. (Of course, it's possible that notwithstanding what it says in its annual report, IBM really didn't make any money in the United States. But based on IBM's $25 billion in U.S. sales in 1987 and its $31 billion in U.S. assets, that hardly seems likely.)

Since May 1, 1988, when the latest "temporary" law expired, the 1977 Treasury regulation has been back in force. Merely keeping that feeble 1977 rule in place would mean retaining upwards of $700 million a year in federal tax revenues compared to the situation under the "temporary" laws, according to the Treasury Department's estimate. Requiring all R&E costs to be allocated strictly by sales, as they should be, would add another $1.7 billion a year to federal receipts.

You'd think that might be an attractive means to cut the budget deficit. But President Bush wants to go the other way. He proposes a permanent change allowing multinational companies to use virtually all their R&E costs—about 97 percent for a corporation like IBM with roughly equal foreign and domestic sales—to offset U.S. income. His plan would be worth more than $900 million a year to IBM alone compared to strict allocation by sales, and would apparently exempt most or all of the computer giant's profits from U.S. income taxes in perpetuity.

Predictably, the administration argues that such generous tax treatment is needed in order to encourage U.S.-based research. That's a laudable goal, but it's worth noting that the tax break would go mainly to companies that do lots of manufacturing overseas. Since manufacturing is considerably easier to move abroad than research facilities, the chief incentive the Bush plan would create seems quite counterproductive in terms of American jobs. If an American company with lots of R&E here might be reluctant to build a plant in, say, Germany, because of the high tax rates there, the Bush plan would take much of the sting out of the move. In effect, American taxpayers would be paying to offset Germany's high tax rates.

Indeed, one has to wonder how sincerely the administration believes its own rhetoric about "incentives," given that $1 billion—two-thirds of the first year cost of its proposal—would be spent making the new rules *retroactive*! (One of the nice advantages of a retroactive incentives is that you know what you've given the incentive for. One of the drawbacks, of course, is that the "incentive" can't have had any impact.)

Rather than making more of a mess of the way we tax (or don't tax) multinational corporations, we should be moving to fulfil the promise of the 1986 Tax Reform Act, by taking a number of steps that could protect the tax base and reduce disincentives that work against American jobs and domestic manufacturers.

IBM in 1987

What May Have Happened

	—Using Book—		*--US Tax Return--*	
($-millions)	US	Foreign	*US*	*Foreign*
Assets:	$30,045	$33,643		
Sales:	25,505	28,712		
% allocation:				
Interest—*	47%	53%	*75%*	*25%*
R&D—	47%	53%	*89%*	*11%*
Income before R&D and int.:	*$5,718*	*$8,817*	*$5,718*	*$8,817*
Interest:	*229*	*256*	*364*	*121*
R&D:	*2,556*	*2,878*	*4,828*	*606*
Income after int. and R&D:	2,933	5,683	*526*	*8,090*
Sheltered inc.:	436	561	436	*576*
Taxable inc.:	2,497	5,122	90	*7,514*
Tax rate:	40%	*59%*	40%	NM
Foreign tax:	—	3,022	—	3,022
US tax, before credits:	999	2,049	36	*3,006*
Credits, except FTC:	160	—	160	—
US tax before FTC:	838	2,049	(124)	*3,006*
FTC:	—	2,049	—	*3,006*
Net U.S. tax:	$838	—	($124)	—

**An actual geographical breakdown of IBM's R&D and interest expenses is not provided in the annual report. In the above table, for book purposes interest was allocated by assets and R&D was allocated by sales. The tax return allocations for R&D and interest are conjectural, but plausible; they were calculated to produce IBM's actual tax bill. Figures that depend on these conjectures are also in italics.*

Technically, our tax code tells multinational companies to report their worldwide profits on their federal tax return, but then gives them a "foreign tax credit" equal to their foreign taxes or 34 percent of their foreign income (whichever is less). The idea is that if a company pays foreign taxes on its foreign earnings that are at least as high as the U.S. corporate tax rate of 34 percent, we won't tax those profits again. But companies that pay foreign tax rates that are higher than the U.S. corporate rate—an increasingly common phenomenon since the our rate was cut to only 34 percent in 1986—have a large incentive to reduce their "U.S. source income" and inflate their "foreign source income" on their U.S. tax returns, since this increases their allowable foreign tax credits and thereby cuts their U.S. tax bills. (Such manipulations do not mean they end up paying higher foreign taxes. There's nothing to prevent companies from telling one thing to foreign tax authorities and something quite different to the IRS.)

To address this problem, we need to change the laws and regulations that now explicitly allow companies to misallocate certain types of expenses. Besides fixing the rules on R&E deductions to require strict allocation based on sales, a primary candidate for reform in this regard is the treatment of corporate interest deductions. The 1986 Tax Reform Act made some improvements in this area—essentially reversing another weak Treasury rule adopted in 1977 that had arbitrarily allowed companies to deduct half their foreign interest from U.S. profits. But the 1986 Act retained the general principle that interest deductions should be divided based on the total value of a company's assets in foreign or domestic locations. This rule is not unsound in theory—after all, the reason corporations borrow money is to invest in various types of capital assets. But in practice the way property is valued (usually by cost minus depreciation rather than by fair market value) and the bookkeeping mobility of financial holdings makes the assets rule fundamentally deficient. A more promising approach would be to allocate interest deductions by gross sales for manufacturing companies (like R&E deductions) or by place of loans, for banks.

Current law's complexity and its opportunities for tax avoidance are augmented by the fact that companies usually don't have to report their foreign income to the IRS until the foreign profits are brought back into the United States. Typically, that happens when a corporation's foreign subsidiary pays it a dividend. Thus, when it comes to foreign-source income, the IRS is usually dealing with dividends paid out of the after-tax income of foreign subsidiaries, perhaps income earned in some earlier year. Major simplification, as well as significant revenues, could be gained by eliminating this so-called "deferral" of tax on foreign profits: companies should report their *total* worldwide pretax profits—and those of their subsidiaries—to the IRS each year as they are earned.

Meanwhile, our tax code continues to encourage companies doing business in high-tax nations to set up manufacturing facilities in low-tax places such as Taiwan, Singapore and Ireland. Corporations now can shelter their tax-haven income from American taxes using "excess" foreign tax credits left over from their high-tax operations. And companies do in fact respond to this stimulus. For example, a spokesman for Prime Computer told *The Boston Globe* in 1987: "We didn't set out to build a plant in Ireland . . . , but the [US] government offered incentive and we took advantage and that lowered our tax rate. If that means we paid low taxes, so be it." By segregating profits earned in low-tax countries from those earned in high-tax countries we could end this perverse inducement to export American jobs.

More fundamentally, perhaps the time has come to reexamine the whole approach we take to taxing multinational enterprises. Under current law, every transaction that an American company has with one of its foreign subsidiaries, or that an American subsidiary of a foreign corporation has with its parent, is an opportunity for tax minimization. If the American corporation, for U.S. tax purposes, charges its foreign subsidiary or parent too little (or pays it too much) for products or know-how, then it will shift profits on its federal tax return to foreign-source income and generate additional foreign tax credits. To try to control those kinds of shenanigans, every deal between a U.S. company and its foreign relatives supposedly is subject to an "arm's-length" test. In theory, this means that deals must be treated the same way as if the company were negotiating with a stranger. But in practice, there's no reasonable way the IRS can keep tabs on all the transactions.

Much can be learned in this regard from the experience of state governments, who face comparable problems when they try to figure out how much profit multi-*state* companies earn in a particular state. That's why most of them have abandoned the impossibly complex "arm's-length" system in favor of a simple formula that allocates profits among states based on a company's sales, payroll and property in each. This formula approach works so well that for a time several states tried to extend it to multinational corporations on a worldwide basis.

In 1983, the Supreme Court upheld California's right to apply its allocation formula globally, rejecting a challenge by Mobil Corp. In its opinion, the Court praised the formula method's "powerful basis in economic theory" and criticized the "basic theoretical weaknesses" of the arm's length system, which, said the Court, "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Unfortunately, this victory for the states was short-lived. After the Court's decision, a concerted lobbying campaign led by the Reagan Treasury Department, the British Government, Mobil and Sony forced California and other states to back off from their "worldwide unitary" approach to taxing multinational firms.

The primary complaint by the Treasury against state use of the worldwide unitary method was that it differed from accepted international practice. Of course, that's true. Certainly, if the U.S. government were to move toward a formula approach to taxing multinational companies, it would require lots of cooperation from other countries. But most foreign governments probably would welcome our taking the lead out of the present morass.

Despite the President's stale rhetoric about "incentives," international tax gamesmanship is a bane on our country, not a boon. Multinational corporations, whether owned by Americans or by foreigners, ought to pay federal income taxes on the profits they earn in this country. And our tax laws should stop giving American companies incentives to move capital and jobs overseas.

III. R&D Tax Credit

The R&D tax credit was enacted with much fanfare as part of the huge package of corporate tax incentives adopted in 1981. Its proponents promised that the credit, on top of already existing tax breaks for R&D, would lead to a big surge in R&D spending by businesses. But there is little or no evidence the credit has served that goal.

The most comprehensive analysis of the R&D credit was published in 1984 by Professor Edwin Mansfield of the University of Pennsylvania. Professor Mansfield notes in his study that R&D did increase at a fairly rapid rate after the tax credit was enacted in 1981, but, he points out, "little can be deduced from this fact alone." First of all:

> "the boom in R and D spending began several years before the introduction of the credit. Indeed, the rate of increase of company-financed R and D seems to have been no higher in 1981-83 than in 1979-81."

And, second, Mansfield points out, "the reported figures are based on a rubber yardstick." Many firms redefined activities as "R&D" in order to take advantage of the credit.

To find out what really happened, Mansfield undertook a comprehensive survey of major companies, in which he asked his respondents to keep their definition of R&D constant. In summary, Mansfield concluded that "the R and D tax credit has had only a modest effect [i.e., 0.4% to 1.2%] on firms' R and D spending." Even more telling, Mansfield found that "the extra R and D stimulated by the tax credit seems to have been considerably less than the revenue loss to the Treasury." Mansfield supplemented his findings with analyses of similar R&D tax incentives in Sweden and Canada, whose "effects were about as small as those of the U.S. tax credit." (In fact, Sweden repealed its R&D tax break in 1983 after a ten-year experiment, "due in part to growing questions concerning the effectiveness of the allowance.")

The big problem for R&D in America today is that far too many of our best scientists and engineers are devoting their careers to working on weapons systems instead of developing new and improved consumer products or business equipment that could help make our nation more competitive. The idea that costly tax breaks are the solution to our economic problems should have been laid to rest with the abject failure of corporate tax incentives to achieve their putative goals after 1981.

IV. Oil & Gas

The administration's final assault on tax reform comes in the oil and gas area. Specifically, the administration proposes:

- *Gutting the minimum tax with regard to tax breaks for "intangible drilling costs."* Under current law, if expensed drilling costs on successful drilling efforts, minus what would have been allowed under 10-year amortization, exceed 65 percent of a taxpayer's oil and gas income, that excess is a tax preference item in the Alternative Minimum Tax. The administration proposes to reduce the amount of excess IDCs that are treated as a tax preference by 80 percent.
- *Expansion of the oil depletion allowance.* The current 15 percent depletion allowance may not exceed 50 percent of taxable income from a property, nor 65 percent of a taxpayers total income. Moreover, percentage depletion is not allowed if ownership is transferred. The administration proposes to allow 100 percent of taxable income from a property to be offset, and to allow transfers.
- *Tax credits for exploratory drilling and enhanced oil recovery projects.* The credits would be 10 percent on the first $10 million in exploratory drilling costs per company per year and 5 percent on amounts exceeding $10 million, plus a 10 percent (unlimited) credit for capital expenditures on new tertiary recovery projects. The credits would be applicable against both the regular and the minimum tax, but could not wipe out more than 80 percent of the latter. The credits would be phased out if the price of oil (current about $20.50 per barrel) exceeds $21 per barrel.

According to the administration, increased tax shelter opportunities relating to oil and gas are necessary to offset the impact of lower oil prices. The stated goal is to stimulate production from "marginal properties" and investments in projects "that are currently too costly." Three things are immediately obvious about the administration's plan:

(1) By weakening the minimum tax, the plan clashes with the tax reform goal of assuring that those with substantial incomes pay a reasonable amount in federal income taxes.
(2) It conflicts with another central premise of tax reform—that incentives for economically unsound activities are not in our national interest.
(3) With an estimated revenue loss of less than $400 million per year, the incentive effects of the plan would necessarily be tiny.

With much to be lost in terms of tax reform principles and little to be gained in terms of added oil exploration, we believe that enactment of the administration's oil and gas proposals is unwarranted.

Conclusion

The 1986 tax reform act represented a drastic change in philosophy by Congress and the Reagan Administration. After years of experience, it finally was determined that tax breaks for corporations and the wealthy are an expensive, inefficient and counterproductive way to try to improve economic conditions. The tax act was far from a complete victory for tax fairness, however. Even after reform, the richest one million people in our country are paying a 25 percent lower share of their incomes in total federal taxes than they were ten years ago, while total taxes on the vast majority of American families are up. Meanwhile, the tax system continues to fail at what ought to be its fundamental task—raising enough money to pay for the cost of government programs.

We can't undo the errors of the past, but we certainly don't have to repeat them. The first step should be to reject President Bush's call for another supply-side round of tax giveaways to the rich. But we also need to persuade the President that extending tax reform, rather than sabotaging it, is imperative if we are to cut the budget deficit and curb the immoral borrowing from our children's future that has been the unfortunate hallmark of the 1980s.

Chairman Rostenkowski. Thank you, Mr. McIntyre. Your testimony and your statement, Mr. McIntyre, opposes the extension of the R&D credit because you feel that it provides no incentive for additional research and development.

Mr. McIntyre. I think that it provides very little; yes.

Chairman Rostenkowski. Do you feel that the President's proposed changes in the structure of the credit would provide any additional incentive over the current credit?

Mr. McIntyre. Well, what the surveys have found, Mr. Chairman, is that typically, the people who are responsible for doing R&D in companies do not have that much connection with the accounting department, and they do the R&D that is necessary to create the company's products and improve them, and later on, the accounting department finds out whether they are entitled to a tax break for it.

So it is unlikely, I think, that you would see much significant impact from tinkering around with this credit. What you would see, however, by increasing the budget deficit, which this does, is a deleterious effect on our trade posture which would probably hurt some of our companies that are competitive in world trade.

Chairman Rostenkowski. Mr. Rahn, you have testified that the chamber supports President Bush's capital gains proposal, and yet you suggest some major changes in that proposal. Let's suppose that we do not make any changes in the capital gains proposal to the President. Would you still support it?

Mr. Rahn. Yes. We think it is a step forward, a step clearly in the right direction. We just do not think it goes far enough.

Chairman Rostenkowski. You are aware that our estimates show that in the long-run the proposal would lose money?

Mr. Rahn. I am aware of those estimates, but I remember back in 1978, testifying before all of you, and being told that the proposals would lose money. That turned out to be absolutely incorrect.

I can still remember testifying here and saying we might raise $1 billion in additional revenue. The actual first-year increase was $2.4 billion. At least I got the direction of my sign right.

I think the empirical evidence is rather overwhelming. Virtually all the academic studies show the lower capital gains tax rate would provide more revenue, and it is an issue that I have looked at carefully over a good many years. Economists do not know for certain, and I have seen studies ranging from 9 percent to 26 percent. Even the CBO study, their best point estimate was 26 percent. That was the high end of the range.

I know of no study which claims that the current 33 percent is the revenue-maximizing rate. But going beyond that, I cannot see the justification for just taxing inflationary gains. We like to talk about fairness, and there seems to be nothing, to me, more unfair in the Tax Code than taxing small farmers and small business people, and others, on gains that are not real gains at all, that just accrue from inflation. And that seems to be——

Chairman Rostenkowski. Well, you know, the proposal, as I interpret it, in the short-run would raise revenue——

Mr. Rahn. Yes.

Chairman Rostenkowski [continuing]. With the accelerated transaction chain. Wouldn't it hold true, if we raised the rates on capital gains—wouldn't activity be created so that people would make the transactions before the capital gains rates were increased as well? So, if we are looking for revenues in the short-run, why don't we raise the capital gains rate?

Mr. **RAHN**. Well, in the very short-run you are absolutely correct.

Chairman **ROSTENKOWSKI**. Well, we are talking of, in this budget process, about a very short run. We are not concerned about what the long-term——

Mr. **RAHN**. But over a 5-year period or so, I think that would be economically disastrous.

Chairman **ROSTENKOWSKI**. Oh.

Mr. **RAHN**. I would hope the Congress would have a longer term time horizon than only the current or next fiscal year.

Chairman **ROSTENKOWSKI**. Mr. Archer will inquire.

Mr. **ARCHER**. Thank you, Mr. Chairman.

Mr. McIntyre, I am curious. You said that the President's proposals provide for a higher tax on most Americans, and I just do not see that in—I will be happy to yield.

Chairman **ROSTENKOWSKI**. I am sorry. I would just like to announce to the committee that there is a vote on. If some of the members would like to retire now, and come back, so then we can continue the hearing with these gentlemen. In the meantime, Mr. Archer will inquire.

Mr. **ARCHER**. I am just curious. I have looked at all the items in the proposal, and I do not see where there is an increased taxation or a higher tax on most Americans involved in the President's proposal. I would like for you to outline that for us.

Mr. **MCINTYRE**. Oh, sure. The telephone tax, most——

Mr. **ARCHER**. That is an existing tax, Mr. McIntyre. It is not a new tax.

Mr. **MCINTYRE**. Well, it is scheduled to expire, Mr. Archer.

Mr. **ARCHER**. It is not increasing taxes on the American public; it is already in the law. Now what other item is there?

Mr. **MCINTYRE**. Mr. Archer, what is already in the law just——

Mr. **ARCHER**. What other item is in there, Mr. McIntyre, that increases taxes——

Mr. **MCINTYRE**. Extending the payroll tax to State and local workers.

Mr. **ARCHER**. That is most Americans?

Mr. **MCINTYRE**. No.

Mr. **ARCHER**. Most Americans already pay that, don't they?

Mr. **MCINTYRE**. Extending the airport tax, extending the schedule——

Mr. **ARCHER**. Now wait just a minute. Don't most Americans already pay the payroll tax?

Mr. **MCINTYRE**. Mr. Archer, you asked me to——

Mr. **ARCHER**. No, just answer; please answer my question. Don't most Americans already pay the payroll tax?

Mr. **MCINTYRE**. Yes, Mr. Archer.

Mr. **ARCHER**. All right. Well, then how can most Americans be affected by covering State and local employees, if most already pay it? Can you explain that to me?

Mr. **MCINTYRE**. I certainly shall. Most Americans are affected by extending the telephone tax, by extending the payroll tax——

Mr. ARCHER. We already talked about that. That is an existing law.

Mr. MCINTYRE [continuing]. And by extending the airport tax.

Mr. ARCHER. Are most Americans affected by those items?

Mr. MCINTYRE. By some of those three, Mr. Archer. You can understand me.

Mr. ARCHER. Well, you know, the point is, Mr. McIntyre, that you have misstated this in your own subjective terms, and I just wanted to make the record clear on that. You know, it is interesting to me. From your testimony, you are clearly against tax preferences and tax incentives, and tax loopholes. Is that correct?

Mr. MCINTYRE. That is a good reading.

Mr. ARCHER. All right. Now tell me: What is your view on the incentives for enterprise zones?

Mr. MCINTYRE. I think that it would be a foolish proposal to be adopted, Mr. Archer.

Mr. ARCHER. But you did not mention that in your testimony?

Mr. MCINTYRE. We were asked in the statement requesting testimony not to testify on enterprise zones until a later date.

Mr. ARCHER. All right. What about the child care credit? What is your view on that?

Mr. MCINTYRE. I think that was scheduled for a later date. My view on it is that an extension of the earned income tax credit—which is what it is, it is not for child care—might be advisable if it can be afforded.

Mr. ARCHER. Now what about the adoption tax provisions? All of these are tax preferences in the code, but you——

Mr. MCINTYRE. Yes. The adoption thing is hard to get very excited about, isn't it, given its low revenue cost?

Mr. ARCHER. No. The point is that you say you are against both tax incentives in the code and tax credits, and yet you want to subjectively pick and choose the ones you like and the ones you do not like.

Mr. MCINTYRE. Well, I have not picked many I like, have I?

Mr. ARCHER. That seems very inconsistent to me.

Mr. MCINTYRE. Mr. Archer, the earned income tax credit is designed to be an offset for payroll taxes, and perhaps, if you want to call that a tax preference, fine; but there are very few tax preferences in the code that I would support. If there is a guiding line, it is, I guess, a question of who gets the money.

Mr. ARCHER. So, basically, you are saying it is like beauty, it is in the eye of the beholder, that——

Mr. MCINTYRE. No. It is a question of distribution, Mr. Archer.

Mr. ARCHER [continuing]. Each person can pick and choose as to what tax preference is tax reform, and what tax preference is not tax reform?

Mr. MCINTYRE. Well, I think that we found that out in 1986. You do have to make choices, yes.

Mr. ARCHER. OK, Dr. Rahn, tell me how many foreign countries tax capital gains?

Mr. RAHN. Well, very few. Most of our major competitors do not tax them at all. The Japanese have recently put in a 5-percent capital gains tax. Of the major industrialized countries, the United States has the highest capital gains tax. And when you see other countries who are successful in their economic policies not having any capital gains tax, or very low ones, that leads you to believe perhaps we are doing something incorrect.

Mr. **Archer**. How do our aggregate capital savings in this country relate to the pool of capital savings in the other major free developed countries?

Mr. **Rahn**. By most common measures we have a lower savings rate than most of our major industrial competitors.

Mr. **Archer**. How do we improve our standard of living without adequate capital savings and capital formation, both of which provide the tools of production? Or would you embrace what is the corollary to Mr. McIntyre's testimony, that it is wrong for us to have what he calls incentives for sending American manufacturers abroad? I would assume that he would like to have incentives for bringing foreign manufacturers into this country, which would be a corollary of that.

Is that the way we should go to get our capital formation in order to have the tools and the capability to increase the standard of living for all Americans by higher productivity?

Mr. **Rahn**. Well, it is clear that you need higher rates of capital formation if you are going to have higher rates of economic growth, which means higher real incomes for all Americans and more job creation. It is also, I think, unambiguously clear, that our tax system discriminates against savings and investment. It is not a neutral tax system regarding consumption and savings and investment, and there are a number of measures that ought to be taken.

The reduction in capital gains rates, in our judgment, would be a major step forward in encouraging more capital accumulation and higher rates of productivity, and more job creation.

Mr. **Archer**. In your opinion, is a reduction in the capital gains rate a tax shelter?

Mr. **Rahn**. Not at all, since most capital gains that are taxed is nothing more than inflation, and I find that economically destructive, and in my view of things it is morally wrong to tax inflationary gains, since inflation is caused by the Government.

What you are really doing then is it is a tax on wealth, and particularly of small farmers and small business people. You are expropriating the assets they build up over time. I think that is wrong.

Mr. **Archer**. Thank you very much.

Mr. **Russo** [presiding]. Mr. Frenzel.

Mr. **Frenzel**. Thank you, Mr. Chairman. That seat becomes you.

Mr. **Russo**. I cannot wait to move in here. [Laughter.]

Mr. **Frenzel**. Mr. Rahn, if the Japanese capital gains rate is five, and we want to compete and do well in international competition, should we set our rate at four or six?

Mr. **Rahn**. Four.

Mr. **Frenzel**. Thank you. I yield the balance of my time.

Mr. **Russo**. Thank you very much. Mr. McIntyre, the chairman wanted me to ask you this question. Do you agree with Mr. Rahn's comment about capital gains in other countries?

Mr. **McIntyre**. Well, it is not factually accurate, but other than that I suppose it is all right. The Japanese are very tough on capital gains other than the stock market. He pointed out their stock market rate is 5 percent. Small business, it is their regular rates. Land sales are even higher. They tend to treat small business gains the same as ordinary income and tax them at the full rate.

The British tax capital gains at the full rate, which is higher than our rate. So, the international picture is mixed. One thing that is clear, however, is that our international competitiveness and our savings rate were at their worst when we had a 60-percent capital gains exclusion.

Our savings rate has come back, and our trade picture has gotten marginally better since the capital gains preference was eliminated. So, if we want to make these kinds of comparisons I think the evidence is reasonably clear on that one as well.

Mr. **Rahn**. Can I make a factual correction there.

Mr. **Russo**. Yes, sir, Mr. Rahn.

Mr. **Rahn**. The British tax rate, the rate is 40 percent maximum as opposed to our 33 percent. They have very few State capital gains taxes, as we do, commonly. But their code is indexed for inflation whereas ours is not.

Mr. **Russo**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman. I apologize for missing the oral testimony of both of you. I have had a chance to look through the written testimony, however. Just a couple of questions.

Mr. Rahn, my understanding was when we did the 1984 Tax Reform Act, at that time, at least—and it may have changed—the effective corporate tax rate in Japan—I am talking about an effective tax rate that was almost exactly double the effective tax rate in this country.

Was that the case, and has that changed, and, if so, how?

Mr. **Rahn**. I do not know for certain.

Mr. **Dorgan**. Would you take it from me that it was the case because that was information that had been developed for us then. What would that tell you about the relationship of tax burden to economic growth relative to paying the bills, et cetera?

Mr. **Rahn**. Well, you have to take a look at the sum total of taxation of capital, and I have seen a number of studies of the cost of capital in Japan versus the cost of capital in the United States, and I know of no study which does not show a significantly lower cost of capital in Japan.

So it is not only the direct taxation of the tax rate, but the base that it is taxed upon. To the extent that you have double taxation of dividends, the rate of capital gains taxation, and so forth, you have to look at the sum total of taxes on capital.

Again, every study I have seen has shown a much lower cost to capital than Japan. There are a number of ways of getting to the desired end, and you cannot just compare any two taxes, in isolation by themselves, to make a judgment on which country has the best taxation of capital.

Mr. **Dorgan**. But in 1986, I asked the Joint Tax Committee, and others, to prepare for me a pretty good summary of the tax structure of all of our major competitors, and, frankly, you know, with the 1981 tax changes on depreciation, and the investment tax credit, and other things, the charges that were made, that we were not competitive in our tax system, and so on, were way off base.

The fact is we were extraordinarily generous in our tax system with respect to corporate taxation vis-a-vis all of our competitors.

The changes that we made in 1986 puts us somewhere back in the middle of the pack, in my judgment, at least with information that I have seen recently.

Let me ask a question, if I might, about targeting capital gains.

One of my concerns about the old capital gains was that, you know, you could buy a piece of pottery a couple of hundred years old, or a painting, and hang it up, that was 200 years old, and sell it 6 months and a day later, and you paid a lower tax rate on that gain than somebody who was outside working and sweating and earning a living.

Would you like to see the old capital gains tax approach back, which includes those kinds of instances?

Mr. Rahn. Well, I think what I am concerned with is the capital gains tax rate on productive investments. You are talking about collectibles. I cannot make a great economic case for why you ought to have a lower capital gains rate on collectibles.

But in terms of productive investment, we are talking about corporate and individual stock, real assets which are used in economically productive activity—clearly, we need to have lower taxes on those.

Mr. Dorgan. So the chamber's position would be that targeting is an appropriate sort of effort and——

Mr. Rahn. Well, you have to always define on what assets your capital gain would be. We thought the administration's definition was too narrow. It excludes timber and corporate capital gains. We think those are mistakes. Depreciable assets—that was a mistake.

Mr. Dorgan. Mr. McIntyre, just one quick question on withholding on earnings by foreign investors. This is off the subject, but as long as you are here, I would like to ask you the question.

Have you been involved, or active in studying the loss to the Treasury as a result of the repeal of that withholding? Maybe the chairman is not listening and I can get by this question without piquing his interest.

Mr. McIntyre. Well, I think the estimates are anywhere from $2 billion to $4 billion a year, but the big reason, I think, for making the United States an international tax haven, as we did back in 1984, was that we were running these big budget deficits.

The Reagan administration, at the time, was worried that interest rates would increase, so they set the United States up as an international tax haven, allowing tax evasion by Europeans and Japanese, and so forth.

It is not a position we ought to be in. We are hurting not only ourselves but other countries' ability to enforce their tax laws. It is kind of like the States all setting up tax exemptions for different companies. Pretty soon everybody has to do it, and we lose the tax base. So that is the real serious harm there.

Mr. Dorgan. How would you recommend we change that?

Mr. McIntyre. I think we should reinstate a relatively low-level tax, that we will, as usual, waive under treaty, as long as the foreign country finds out about their investors' earnings. If they would rather evade their home country's taxes, then we will collect the tax. If we set it low enough, we will probably collect a lot.

Mr. **Dorgan**. The assumption is that much of that is now nowhere earnings for international tax purposes.

Mr. **McIntyre**. Oh, there is no doubt about it. The Eurobond market is set up as a tax evasion market.

Mr. **Dorgan**. I raise that point because that is a point this committee needs to discuss with respect to revenue. How much did we ever collect on the tax before?

Mr. **McIntyre**. Well, the way it was set up before, it was set up that everybody filed for an exemption under a treaty, but then they paid taxes to their home country, which is fine with me. That is what a high-level tax does, and we then serve the role of policing—as we ask other countries to do for us—of their citizens and our citizens.

If we set a low-level tax, we would collect a lot of revenue because people would continue to evade overseas.

Mr. **Dorgan**. Mr. Rahn, do you have an observation about that?

Mr. **Rahn**. I do not know. I just believe in freedom, and——

Mr. **Dorgan**. Not to evade taxes.

Mr. **Rahn**. I am not so sure that we ought to be in the business of policing other countries' citizens. I do not think that is a proper role for the United States.

Mr. **Dorgan**. But if, by definition, you create substantial amounts of international nowhere income that you understand will not be reported to the country which was the source of the income, or the country which is the home or the recipient of the income, it seems to me that you have created what Mr. McIntyre says is an international tax haven.

Mr. **Rahn**. The result of this is to create more capital formation throughout the world. If you tax capital less throughout the world, you have more capital available for productive investment which means higher growth levels, and citizens throughout the world will be more prosperous over the long run.

Mr. **Dorgan**. I suppose there would be more economic growth in my neighborhood if I did not have to pay taxes as well.

Mr. **Rahn**. Sure.

Mr. **Dorgan**. I would probably spend more around the neighborhood. The reason I raised the question is I think that that is an issue that, Mr. Chairman, we ought to discuss. I know you and I disagree on that issue, but I think that it is one that is of significant-enough consequence, that the committee should begin to discuss it.

Again, let me thank both of you for submitting some interesting, if conflicting, but still interesting testimony on capital gains. It is very useful to the committee. Thank you.

Mr. **Gibbons** [presiding]. Let me ask you, Mr. Rahn and Mr. McIntyre, on the old capital gains we included in the items such things as Christmas trees. Now you would not include Christmas trees, would you?

Mr. **Rahn**. Well, Christmas trees do have a long life cycle in terms of crops, unlike, you know, wheat, I guess—the Christmas tree crop—I am not an expert on Christmas trees so I cannot talk much about this. I guess the life cycle there is 5 or 6 years. Clearly trees, in general, it seems to me that people across the political spectrum think we ought to grow more trees in this country for environmental reasons, and a lot of other reasons.

Mr. **Gibbons**. How about stamp collecting, and things like that?

Mr. **Rahn**. Well, collectibles I—again, I cannot make an economic case for collectibles.

Mr. **Gibbons**. You would drop those out of your package, is that right?

Mr. **Rahn**. But even there, I do not think people ought to be taxed on just inflationary gains.

Mr. **Gibbons**. How about raw land, where they do nothing to it?

Mr. **Rahn**. Well, there, as long as you excluded the inflationary gain.

Mr. **Gibbons**. I would agree with you. You probably ought to try to exclude inflationary gains but not try to just tax inflation, but that is very difficult to do.

Mr. **Rahn**. I mean, to make the thing just—I think what you are driving at—to make the thing just economically correct, with each different type of asset, we could end up with an extraordinarily complex capital gains law, and we, at the chamber, have looked at this, have looked at various assets and what is the proper way to tax the gain on each particular asset.

The problem is, once you get into too much differentiation here, the legal complexity becomes so great it may not be worth the effort.

Mr. **Gibbons**. How about an owner-occupied residence?

Mr. **Rahn**. Owner-occupied residences? Now, of course, we have the rollover and they have the $125,000 exclusion, after age 55.

Mr. **Gibbons**. Yes; we have that. That is mainly to try to get the inflation out of it.

Mr. **Rahn**. Yeah. Well, the main thing, with those type of issues, I do not think anybody ought to be taxed just purely on inflation.

Mr. **Gibbons**. But you can get a capital gain on the sale of your residence without even rolling it over. You do not have to roll it over. I mean, you do not have to go to the one-time exclusion.

Would you give a sale of personal residences a capital gains treatment?

Mr. **Rahn**. Would I give a sale of personal residence capital gains treatment?

Mr. **Gibbons**. Yes, sir.

Mr. **Rahn**. As we do now? Yes.

Mr. **Gibbons**. Well, doesn't that really have the effect of just——

Mr. **Rahn**. I mean, I think we ought to index any gain that a person gets with a personal residence. I do not think, again, they ought to be taxed on inflation.

Mr. **Gibbons**. Yes. Well, I think we can all agree on that. I guess we can. Can you, Mr. McIntyre? We ought not be taxed on inflation?

Mr. **McIntyre**. I think it is worthwhile, if you want, to discuss indexing. It is obviously very complicated. You would need a much higher top tax rate, say, 45 percent. You would need to index not only gains but interest deductions, and other items to make it work, and, if you did all those things the system might be marginally fairer but it would be a lot more complicated. I doubt that Mr.

Rahn would want to make that deal because of the higher tax rate involved.

Mr. RAHN. It would not require higher tax rates.

Mr. GIBBONS. Let me give you a little simple illustration of our tax system, and you tell me where I am wrong because I have given this illustration a lot of times and most people do not find fault with it.

If you manufacture this in the United States when it leaves this country and goes abroad there is no adjustment for cost to the Government before it goes to retail.

Is that correct?

Mr. RAHN. Yes.

Mr. GIBBONS. Except in the foreign country most of them have a use tax added to it——

Mr. RAHN. Or value-added tax.

Mr. GIBBONS. It does have the cost of the foreign government when it goes to retail.

Now when it is manufactured in the foreign government and comes out, they knock off their value added tax—or their use tax—but when it comes into our country we do not do anything to it, so if it goes out of our country and goes into their country—manufacture of ours sold in theirs—it has two costs of government on it: ours and theirs. When it is manufactured in their country and comes to retail in ours it does not have any cost of government in it.

Mr. MCINTYRE. That it not technically true, Mr. Gibbons. Foreign countries have many other taxes besides sales taxes, and we do impose our income tax on profits earned by foreign companies in this country. The States impose their sales taxes and their income taxes. Our average State sales tax is much higher than, say, the new Japanese VAT. The cost of government in this country is so much lower than it is in most foreign countries that I think any burdens you could figure were imposed by us on American products are less than on the exports from most foreign countries.

It is a little hard to figure that sales taxes—which I guess you are implying we need—are the key to export growth. Obviously, the Japanese did pretty well without one for a very long time.

Mr. GIBBONS. Don't we penalize our products against the rest of the world? Why don't we?

Mr. MCINTYRE. Again, when our products go overseas they have paid some tax, although often not very much because it is an export. We do not tax exports generally under the corporate income tax. When our products go overseas, and if there is profit earned over there the company may pay some foreign income tax. We are very generous to our exports under current rules. It is similar to what foreign countries do. The Japanese pay some Japanese corporate tax. They may pay some American corporate tax on their profits here, and that is basically what the situation is. It is very similar in both countries.

Mr. GIBBONS. Thank you.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire?

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Rahn, I assume that you support the President's policy of not asking for any new taxes?

Mr. **Rahn**. Absolutely.

Mr. **Rangel**. You indicated in your testimony that you thought that the congressional view on taxes on capital gains was spiteful in that it is viewed as a policy to increase the benefits to the wealthy, but in fact it primarily benefited the low- and middle-income wage earner.

I have never read that or heard that before. Will you share with me where you got that statistical data?

Mr. **Rahn**. Well, quite clearly that taxing inflation rather than real gains seems to me to be fundamentally wrong. The Government creates inflation. It is nothing more than expropriation of people's assets.

It is quite clear that lower capital gains taxes results in higher levels of capital formation, more business investment, and more new jobs being created.

Mr. **Rangel**. You are talking about, then, in the long run the ultimate beneficiary would be all Americans?

Mr. **Rahn**. Yes. The person without a job—if you created more jobs——

Mr. **Rangel**. Most capital gains are realized by people who have recurring incomes in the middle- and low-income ranges. That is your statement?

Mr. **Rahn**. Yes.

Mr. **Rangel**. Where do you get information to support that statement?

Mr. **Rahn**. That is IRS data.

Mr. **Rangel**. What is it?

Mr. **Rahn**. It is IRS data.

Mr. **Rangel**. Just like that? Can you——

Mr. **Rahn**. The 1985 individual tax model from the IRS.

Mr. **Rangel**. Well, that flies in the face of every other document including—have you had a chance to look at that with the Joint Committee? You have never seen this any place else before, have you? Did it not surprise you when you saw it?

Mr. **Rahn**. Not really. I had anecdotally understood that—what happens is a person has a small—a person of a modest or middle income has a capital gain 1 year. That year they appear to be at a very high income level. Typically though they may be making $30,000 a year. After holding an asset 20 years they have a $60,000 capital gain——

Mr. **Rangel**. Well, this helps me. If I can sell this as really a benefit for the low-income people you have made my job a little easier.

Mr. **Rahn**. For low-income people it creates jobs and economic growth.

Mr. **Rangel**. No; that is the long-range. This is a short-range policy. I refer to the 1986 document from the IRS that basically this is a tax benefit from middle- and low-income people and has to chain this position, so we can leave that alone.

The other part of the administration's posture—at least that the President talked about—was highlighting some new initiatives, and the President talked about this fight against narcotics, which I assume has some impact on productivity. He talked about the plight of the homeless, and specifically that he wanted it to be clear that he was an educational President—again I think that is connected with the business as it relates to creating jobs skills.

Now all of these things cost money, and I assume you support them because the President supports them, and I certainly do, but you are saying that if we support the President and these new initiatives that we should compensate by reduction in other programs?

Mr. **Rahn**. Yes. I think there is obviously a number of government programs where you could have reduced outlays which would be beneficial. There are a lot of asset sales we could engage in. There is no reason to subsidize Amtrak.

Mr. **Rangel**. I see.

So, you have already looked at the President's spending program, and I assume that you support those, especially——

Mr. **Rahn**. Yes—most of them. Some we do, and some we do not.

Mr. **Rangel**. Could you tell me which ones you would likely give Congress priority to cut because if we just drop those new initiatives and get into a cutting mode, maybe we would not have to raise much revenue. But if the chamber really wants to invest in people, could you tell me which ones that either the President suggested or the chamber has looked into that you would support?

Mr. **Rahn**. We have supported heeding the Gramm-Rudman targets without tax increases.

Mr. **Rangel**. No; I meant programs, sir.

Mr. **Rahn**. I understand.

We have not gone through and said which programs we thought more money ought to be spent on. We have identified a number of areas where we thought less money could be spent.

Mr. **Rangel**. Mr. Rahn, let me ask this.

Don't you believe that certain programs improve the economy, increase job skills, increase productivity, that are good for business, raise revenues, make America competitive? Aren't these the type of things that have you concerned?

Mr. **Rahn**. I think relatively few government programs do these. I think they are advertised as doing that, but when you look at the total extraction costs in the private sector, what it costs to get the dollars the Government spends, the empirical evidence is, from not only looking at the United States but around the globe, as government grows as a percentage of GNP, economic growth tends to slow down.

Mr. **Rangel**. So, would the chamber's position be that the problems that we face in the international and national drug crisis, that problems we face with homelessness, that basically those should be left to local and State governments and the Federal Government should be left out of it?

Mr. **Rahn**. We are not saying totally out of it. Most of these things do not have——

Mr. **Rangel**. One program, Mr. Rahn, not totally—just anything. Health care, maybe—whatever. I don't want the chamber to walk away from here without supporting anything in terms of a program.

Is there anything that we are spending on that involves human beings and improving their lives that you could support as being productive—an investment that you could support, that is all?

Mr. **Rahn**. Over the years we have supported a number of——

Mr. **Rangel**. Today, Mr. Rahn.

After reading the President's recommendations to the joint session—I know that you did not just look at the tax part and those that benefit business, you look at those that benefit our great Nation. I am just saying in the other part, what did you come up with as saying that Congress had to support?

Mr. **Rahn**. We did not make a list of programs which we would like the Congress to spend more money on.

Mr. **Rangel**. Thank you.

Mr. **Rahn**. We are often asked where can you get the money to balance the budget, and we have made a list of asset sales, user fees, and spending reductions on programs to get to a balanced budget.

Mr. **Rangel**. You have been very helpful.

Thank you.

Chairman **Rostenkowski**. Mr. Brown.

Mr. **Brown**. Thank you, Mr. Chairman.

Mr. McIntyre, I appreciate your testimony this morning. I ran an export company for 3 years. We apparently missed a lot of tax breaks. You said that exports do not pay taxes. We paid property taxes. We paid employee taxes. Our employees paid income taxes. We pay corporate taxes. We pay franchise taxes. We pay business taxes.

There is a minor provision in the tax law that allowed a small portion of export earnings to be exempt, but I would be interested in knowing how you support your statement that exports do not pay taxes?

Mr. **McIntyre**. I said they did not pay very much in corporate taxes, and that is true for most of our U.S. exports.

Mr. **Brown**. Can you tell us how that works out?

Mr. **McIntyre**. It is done through a number of ways. The FSC program is the current one. Prior to the FSC, there used to be the DISC Program. There is a lot of work that the companies will do to shift the point of sale, although that is a little bit harder after tax reform so they can avoid corporate taxes that way.

Mr. **Brown**. Well let's go back to the program you mentioned. Tell me, are you saying that program allows a 100-percent exemption for prices on exports?

Mr. **McIntyre**. I said it allows most corporate taxes to be avoided in conjunction with some of the other things.

Mr. **Brown**. Just how does that do that?

Mr. **McIntyre**. Basically, it sets up a mechanism where you move your export sales to the FSC. I forget the exact portion that is currently exempt, but it used to be 100 percent and moved down to 50 percent. I think the FSC's are within that range, and that portion is exempt if they are sold through there. If you do the right bookkeeping you can allocate costs, and up the percentage to considerably more than half.

Mr. **Brown**. Let us be more specific because we used to compete against Ireland. Ireland had an exemption from income taxes for employees that worked in exporting products. Are you suggesting that America has an exemption from income taxes for people who work on export products?

Mr. McIntyre. Absolutely not.

Mr. Brown. Now how about property taxes. Are export companies exempt from property taxes?

Mr. McIntyre. I would suggest that the income taxes the employees pay have absolutely nothing to do with the price of the products.

Mr. Brown. I think that statement reflects your attitude and understanding, and I will leave it at that.

Let me just suggest that you have come before this committee and misrepresented the tax law, and I do not think that is helpful to our deliberations.

Mr. McIntyre. Mr. Brown, I hope that that statement that was just made you could soften. I have not misrepresented, but spoken to the best of my knowledge, and I would hate to have that false statement of yours on the record.

Mr. Brown. Let me say quite clearly that if you are contending that exports by U.S. corporations do not pay taxes if they are profitable, you may want to do a little more research into tax law.

Mr. McIntyre. What I said was, and I will repeat it, they do not pay much in corporate income taxes on the exports, and I will stick by that.

Mr. Brown. Fine.

Mr. Dorgan. Mr. Brown, would you yield on that point?

Mr. Brown. I would be happy to yield on that point.

Mr. Dorgan. I think there is a substantial amount of evidence over the past decade with respect to the practice of using the DISC corporations, and I am not nearly more familiar with FSC, but certainly with DISC that major American firms involved in exporting have been able to avoid substantial amounts of corporate income tax by that mechanism.

Mr. Brown. I accept your point. I think the point here is that there are major taxes paid by export operations that are often not paid by some of our competitors overseas.

I think, when you address this issue, it is a mistake to give the people the impression that our people are not paying taxes on exports, particularly in a competitive environment in which we find ourselves at a disadvantage. I am not necessarily an advocate of the policies that you have outlined, but I think it is important for Americans to have a clear idea of our competitive situation here, and to suggest that Americans do not pay taxes while others do is not the case. I am not suggesting you have implied that for overseas people.

I think it is important here to get a clear picture of what we do with exports, and frankly, I think the statements by the gentleman from Florida raise a very troubling point. We are in a situation, particularly with the European common market where they have a significant tax advantage.

Let me just turn to the chamber, if I could for a moment.

Do you believe that it is necessary for us to index interest rates?

Mr. Rahn. Not at all.

Mr. Brown. What about an index for capital gains?

Mr. Rahn. Of course not, because the interest is always paid by someone along the line. I do not see what you achieve by going ahead and indexing interest rates.

Mr. BROWN. What about indexing capital gains? Do you see a simple way to do that that does not involve a significant paperwork burden?

Mr. RAHN. The simplest way to treat capital gains, of course, is exclusion. You asked about the indexing. I have to admit there is debate among the tax professionals I have talked to of how simple you can make it so you index the basis. Most people I have talked to believe it is indeed possible, I think, without difficulty. But the chamber tax committee did come down in preference of the exclusion rather than indexation for two reasons, one being that indexation was more complex, and secondly you do not do anything about the risk capital and investment risk.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. GIBBONS [presiding]. All right.

Let's see—Mr. Stark?

Mr. STARK. Thank you, Mr. Chairman.

Mr. McIntyre, I have a list which I think was part of some literature that you provided that lists 26 companies—I guess all major corporations, Allied Signal, Baxter, DOW, General Electric, General Motors, and so forth—IBM—and it lists their Federal income taxes, and it compares what they have paid since tax reform and what they paid in the 4 or 5 years from 1981 to 1985. Do you have that data?

Mr. MCINTYRE. Yes; I would be happy to submit that for the record, Mr. Stark.

Mr. STARK. Without objection I would like to have it made part of the record, Mr. Chairman.

[The following was subsequently received:]

Which Companies Are Interested in Section 861 Legislation and What They Pay in Federal Income Taxes

A NUMBER OF CORPORATIONS HAVE BEEN LOBBYING CONGRESS to establish permanent rules under section 861 of the tax code that would allow companies to deduct most of their U.S.-performed, but foreign-related R&D costs against their U.S.-source profits for purposes of computing the foreign tax credit. Various "temporary" rules have allowed this practice during the 1980s, and President Bush has proposed to make a somewhat more costly version of the "temporary" rules permanent (retroactively).

An analysis of the annual reports of 26 of the leading companies involved in lobbying for permissive section 861 legislation indicates that, in the aggregate, these corporations have paid very low effective federal income tax rates. Indeed:

- In 1986 and 1987, the 26 companies earned a total of $35 billion in domestic profits, but paid less than 3 percent of that in federal income taxes (down from a 15 percent effective tax rate from 1981 to 1985).

- Between 1981 and 1987, the 26 companies enjoyed a total of 40 "no-tax years" among them.

- Over the seven year period from 1981 to 1987, the 26 companies paid less than 10 percent of their domestic profits in federal income taxes on a total of 86 occasions—in other words, almost half the time. On more than $57 billion in profits in those low-tax years, their overall effective tax rate was *negative*, that is, *minus* 3.7 percent.

- While many factors undoubtedly came into play in cutting tax bills for these companies, the various "temporary" section 861 rules assuredly played a significant role in many cases. IBM's annual report, for example, indicates that misallocation of R&D deductions was *the* critical factor in its negative federal income taxes in 1986 and 1987.

A table summarizing the 1981-87 domestic profits and federal income taxes of the 26 companies is attached.

Citizens for Tax Justice
April 10, 1989

26 Companies Interested in Section 861 Legislation & Their Federal Income Taxes, 1981 to 1987

($-millions)

	1986-1987			1981-1985			*NT yrs*
Company:	**Profit**	**Tax**	**Rate**	**Profit**	**Tax**	**Rate**	*81-87**
Allied Signal	$1,359	$162	11.9%	$1,319	$46	3.5%	*2*
American Cyanamid	224	22	9.7%	439	(17)	−3.8%	*3*
Baxter Travenol	333	(28)	−8.4%	719	(19)	−2.6%	*2*
Corning	237	29	12.1%	172	11	6.2%	*3*
Digital Equipment	1,148	358	31.2%	1,560	377	24.2%	—
Dow Chemical	1,407	361	25.7%	771	(200)	−25.9%	*3*
Eaton	315	65	20.5%	712	144	20.2%	*1*
FMC	464	110	23.7%	976	145	14.8%	*1*
General Electric	5,226	975	18.7%	12,927	157	1.2%	*3*
General Motors	4,449	(2,670)	−60.0%	18,493	4,396	23.8%	*2*
GTE	1,511	170	11.3%	6,775	489	7.2%	—
Hewlett-Packard	681	6	0.9%	2,075	393	18.9%	*2*
Honeywell	376	123	32.6%	1,086	236	21.7%	—
IBM	5,350	(390)	−7.3%	26,927	5,797	21.5%	*2*
International Paper	998	74	7.4%	1,266	6	0.5%	*2*
ITT	1,218	282	23.2%	682	(230)	−33.8%	*4*
McDonnell Douglas	820	2	0.3%	1,953	15	0.7%	*2*
Merck & Co.	1,425	419	29.4%	2,331	312	13.4%	—
Monsanto	858	102	11.9%	1,189	363	30.5%	—
Motorola	357	85	23.8%	909	171	18.8%	—
Pfizer	1,163	158	13.6%	1,760	291	16.5%	—
Rockwell International	1,861	151	8.1%	3,229	729	22.6%	*1*
SmithKline Beckman	853	185	21.6%	2,075	397	19.1%	—
TRW	489	105	21.5%	1,254	276	22.0%	*1*
Westinghouse	1,720	176	10.2%	2,713	65	2.4%	*2*
Xerox	625	11	1.8%	1,188	(34)	−2.8%	*4*
Total, 26 companies:	**$35,469**	**$1,041**	**2.9%**	**$95,499**	**$14,314**	**15.0%**	*40*

Summary: Companies Paying 10% or Less

Year	No.	*% of***	Profit	Tax	Rate
1987	10	*38%*	$9,480	($697)	−7.4%
1986	15	*58%*	11,369	(1,717)	−15.1%
1985	13	*62%*	13,665	804	5.9%
1984	9	*35%*	5,160	153	3.0%
1983	11	*42%*	4,811	(149)	−3.1%
1982	16	*64%*	6,391	(436)	−6.8%
1981	12	*46%*	6,540	(92)	−1.4%
1981-87:	86	*49%*	$57,415	($2,134)	−3.7%

**Number of years between 1981 and 1987 in which a company paid no federal income tax.*

***Percent of profitable companies paying 10 percent or less of domestic profits in federal income taxes.*

Mr. Stark. Where did you get the data?

Mr. McIntyre. It is from the companies' annual reports.

Mr. Stark. OK.

And what I am seeing here is that these 26 corporations from 1981 to 1985 had profits of $95 billion, and in that period paid only $14 billion and change in Federal income taxes for about an average rate of 15 percent.

Those same companies in the 2-year period of 1986 and 1987 had $35.5 billion in profit—paid $1 billion in tax, or an average rate of only 2.9 percent.

What significance is there in those two figures to show that we are getting—and some of those are being zeroed out. General Motors made $4.5 billion in profit, and got a refund of over $2.5 billion for a negative rate of 60 percent. IBM paid $5 billion plus in profits and got a rebate of $390 million.

What is the significance of these numbers?

Mr. McIntyre. The list of the companies, Mr. Stark, are companies that have expressed interests in section 861 legislation, the administration's proposal on allocating R&D deductions, and some of these companies—IBM in particular, but I am sure others—have been taking advantage of the current so-called temporary rules to basically shift some or all of their taxable profit out of the United States, maximize their foreign tax credits, and pay little or no Federal income taxes.

I thought that, given this committee's interest in considering this legislation, you may like to know who you are giving the money to.

Mr. Stark. Is it your testimony that the reason most of these companies have such huge foreign tax credits which they cannot use up is that they have been shifting manufacturing jobs offshore?

Mr. McIntyre. Well, in order to take advantage of the 861 rules you need to do research in the United States, and you need to do sales and manufacturing overseas. That combination is required, so a company that is purely domestic, for instance, that does R&D and makes sales here, would get no benefit. A company that did R&D overseas and did manufacturing overseas would get no benefit. You have to have that mix.

Mr. Stark. I am looking—I would love to know about tax planning to play the Devil's advocate for a minute, but the people that suggest that this makes no never-mind are going to say that these are merely accumulated tax credits overseas or some aberration of a temporary nature that will not continue, or would you say that corporate tax policy—that there are such generous opportunities for zeroing out that the 861 policy would drive jobs overseas?

Mr. McIntyre. I think it could. We are in a situation now where we have very low corporate taxes compared to the rest of the world, and as a result other countries, you might say, are discouraging our companies from moving there. But the 861 rule says "don't worry about it. We'll pay your taxes for you if you go overseas."

Mr. Stark. On one other matter for just a moment.

Could you explain to me very briefly what the basis of the reasonable and necessary rule relative to executive compensation, what the basis of that is and is that applied anymore to your knowledge in corporate instances?

Mr. **McIntyre**. I remember the purpose of it. This was a long time ago, Mr. Stark, but I have not kept up with it recently to know if it is still an important issue.

Mr. **Stark**. What was the purpose?

Mr. **McIntyre**. They are trying to keep people from changing dividends into deductible wages. That was the idea.

Mr. **Stark**. Under the present Tax Code wouldn't that be advantageous to shift for——

Mr. **McIntyre**. It could be in certain circumstances—sure.

Mr. **Stark**. Thank you.

Mr. **Gibbons**. All right.

Mr. Pease.

Mr. **Pease**. Thank you, Mr. Chairman.

Mr. Rahn, I was interested in your testimony that "most capital gains are realized by people who have recurring incomes than the middle income or lower income ranges." You talked about that with Mr. Rangel before.

How do you square that with figures from the Joint Tax Committee that show 57 percent—I believe it is—of all capital gains benefits go to those earning over $100,000 a year?

Mr. **Rahn**. Because when low- or moderate-income people have a capital gain in excess of their income for 1 year the way the data——

Let's assume you make $30,000 a year, and you sell your family farm for $150,000. That year you report having an income of $180,000. But that is not your typical yearly income nor does it reflect your lifestyle.

Mr. **Pease**. Mr. McIntyre, would you like to comment?

Mr. **McIntyre**. I have seen the table in Mr. Rahn's testimony. What is amusing about it is that it is 1985 data, and it looks at 85 AGI's excluding capital gains.

As you may recall before tax reform, half of the richest people in this country were paying less in taxes than a family of four at the poverty line. That is the chamber's "under $20,000 group with capital gains"—very rich people with tax shelters.

Mr. **Pease**. I was going to say, Mr. Rahn, I cannot believe that this Joint Committee on Taxation could be so sloppy as to count the income only in the year that somebody made a realization. Therefore, I have to come to the conclusion that you are trying to mislead the public and the committee with that statement.

Now you also said "virtually all of the academic studies support the chamber's position that a lower capital gains rate will actually increase revenue."

I find that extremely hard to believe, Mr. Rahn. I have seen some other studies. Certainly I would not say that most of them would support your position. Quite the contrary.

Mr. **Rahn**. I do not believe that that is correct. We have collected every study we could find on capital gains, the relationship between rates and revenue, and virtually all that I am familiar with, and we are not trying to exclude any. We're trying to collect as many as possible to show that a lower rate than 33 percent would maximize revenues. In fact I know of no study which shows revenue maximizing effects of over 33 percent.

Mr. **Pease**. Mr. Rahn, could you supply for the record your list of those academic studies which support your position and those which do not?

Mr. **Rahn**. We will be pleased to do so.

Mr. **Pease**. I would appreciate that very much.

[The following was subsequently received:]

STUDIES AND RESEARH SUPPORTING THE PROPOSITION THAT A REDUCTION OF THE CAPITAL GAINS TAX RATE TO ABOUT 15% WOULD INCEASE REVENUE.

"Revenue Effects of the President's Capital Gains Proposal"
Department of the Treasury, Office of Tax Analysis, 1989.

"The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," by Michael R. Darby, Robert Gillingham and John S. Greenlees
U.S. Treasury Department Study, 1988.

"Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," March 1987, Dr. Lawrence B. Lindsey, Harvard University and the National Bureau of Economic Research.

"The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," Martin Feldstein, Joel Slemrod, Shlomo Yitzhaki
Quarterly Journal of Economics, June 1980

STUDIES AND RESEARCH SUPPORTING THE PROPOSITION THAT A REDUCTION OF THE CAPITAL GAINS RATE TO ABOUT 15% WOULD LOSE REVENUE.

"Analysis of the President's Proposal on Capital Gains"
Joint Committee on Taxation, 1989. (Although this study shows that reducing the rate to 15 percent would raise $3.3 billion in fiscal Year 1990)

"How Capital Gains Tax Rates Affect Revenues: The Historical Evidence," March 1988, Congressional Budget Office Study. (Although this study did not rule out the possibility that 15 percent was revenue positive; moreover it showed the revenue maximizing rate to be below the present 33 percent maximum)

"Capital Gains," in Henry J. Aaron & Joseph Pechman, eds., "Taxes Affect Economic Behavior," Joseph J. Minarik, (Washington, DC: Brookings Institution, 1981). See also "Comment" in the Quarterly Journal of Economics, Minarik, February 1984.

Mr. Pease. Your contention is that this Bush capital gains proposal would be good because a lower rate would "dramatically increase capital gains realizations."

Would it be a reasonable corollary to assume that an increase in the capital gains rate would therefore produce fewer capital gains realizations?

Mr. Rahn. Certainly. We looked at what happened during the 1970's when we increased the rates sharply, realization went down, and revenue went down.

Mr. Pease. I believe that Lawrence Lindsey, whom the chamber loves to quote, predicted in testimony a couple of years ago that the 1986 act which raised the capital gains rate would cause a drop in capital gains realizations from about $150 billion in 1986 to about $80 billion in 1987. In fact the IRS tells us that actual 1987 realizations were $137 billion, a drop of only $13 billion.

When we look at these figures, what would lead us to believe that there is going to be a dramatic increase in realizations as a result of a drop at this point?

Mr. Rahn. I have not seen that most recent data that you just cited, but if you look historically at what has happened. I just go back—what I would recommend is you might want to read the testimony from the 1978 debate on capital gains before this committee. There were a good number of folk who came in here, including the Joint Tax Committee, saying how much of a loss this would be.

Mr. Pease. Mr. Rahn——

Mr. Rahn. Those on the other side at least had the sign correct. The same thing happened in 1981.

Mr. Pease. Mr. Rahn——

Mr. Rahn. The revenues went up, they went up from roughly $8 billion before you had the cut in 1978 to $46 billion in 1986. You don't have to be a mathematical whiz to figure out there's an inverse relationship here between rates and revenue.

Mr. Pease. Mr. Rahn, you are, I believe, an economist. Were there any other factors at work in the period after 1981 that might have contributed to the increase in revenue to the Federal Government? How about a stock market run-up, for example? Would that have any influence at all?

Mr. Rahn. Is a stock market run-up at all related to lower capital gains rates? Now, would you expect higher stock market prices next year if the capital gains tax rate was lower or higher? Well, clearly, you would expect the higher stock market if the capital gains rate was lower because the effect of rate on return would be higher. That's no particular mystery.

When we cut tax rates in 1981, we increased the rate of return to capital. Of course, you would expect the stock market to be higher.

Mr. Pease. Mr. Rahn, my time is up. I would like to thank you for your testimony. Thank you very much.

Mr. Gibbons. All right. Well, we don't want you to be embarrassed.

Let's see. We've got Mr. Schulze.

Mr. Schulze. Thank you, Mr. Chairman.

If I were a chamber member, I think I would send in a contribution. [Laughter.]

I do have some concern over the Bush capital gains proposal because it does not include real estate.

The average American's involvement with the capital gains tax occurs when they sell their principal residence. I realize that there are those who might dabble in the stock market a little bit here and there and some of these other things, but most people's deepest involvement is from sale of their principal residence.

As perhaps you are aware, I have a measure which would eliminate capital gains taxation on the sale of principal residence. My question is twofold.

No. 1, would you favor the inclusion of real estate in general? I would like your thoughts on the complete elimination of capital gains on the sale of principal residence.

Mr. **Rahn**. We certainly would want real estate to be included in any capital gains tax reduction. The total elimination of the tax on the personal residence, I think that gets beyond just strictly economic policy into more of a social policy of encouraging home ownership in equity to homeowners. We have not taken a position on that. I doubt there would be much opposition within the chamber to that, if any. But we have not taken a position on that particular provision.

Mr. **Schulze**. Well, Dick, let me also say that I do not find an awful lot of enthusiasm for a capital gains bill which is solely or mainly oriented toward the stock markets and toward the purchase and holding of securities.

Mr. **Rahn**. I agree with you. I think the administration made a mistake by having a too narrowly drafted bill. I think that, as I had encouraged when they were working on it, they should have a much broader bill in the interest of both economic growth and equity.

Mr. **Schulze**. If they are going to broaden it, it seems to be one of the things which would make the measure relate to the average citizen. By the way, the preliminary estimates we're getting from Treasury on the cost of this is somewhere between $300 and $400 million. Also, it brings simplification; you do not have to keep all the records every time you put an addition on your home or an improvement, or do you keep all those records over a 20- or 30-year period. If we are going toward simplification, they certainly head in that direction.

So it seems to me that if we want something to put in a capital gains measure, which will broaden and enhance the general appeal, the total elimination of capital gains on principal residence would be one of the ways to go.

I thank you for your testimony, and thank you, Mr. Chairman.

Mr. **Pease** [presiding]. Our next inquirer will be Mrs. Kennelly. Mrs. Kennelly, would you like to inquire?

Mrs. **Kennelly**. Thank you, Mr. Pease. Yes.

Mr. McIntyre, I'm sure that the third panel will probably take this up at greater length. But in your writings, and you alluded to it this morning, you say that the Bush administration suggestions for R&D allocation rules will send jobs overseas.

Now, one of the reasons that I've always supported this type of allocation rule is to keep the jobs here.

Is this just a tradeoff you're talking about? Is it a contradiction of terms, just a difference of opinion? Could you just elaborate a little more on that for me?

Mr. McINTYRE. Well, in order to take advantage of the current temporary 861 rules, which the President proposes to extend permanently, a company has to do research in the United States, which involves hiring people, and has to do manufacturing overseas, which involves hiring people.

Now, most people who analyze this think it's much easier to move manufacturing jobs overseas than to move research jobs, because you need the educated people to do research, while often you can deal with less educated people for assembly work.

So, when you try to figure out what's the primary incentive here, it looks to a lot of us that it's to move manufacturing jobs overseas.

You have to do both in order to take advantage of these regulations.

Mrs. KENNELLY. So, it's double jeopardy?

Mr. McINTYRE. Well, I think that the primary effect of the Bush proposal would be to make it easy for many big companies to avoid taxes.

The secondary effect would be to provide some incentive to move jobs overseas. These are lots of reasons why jobs could end up abroad, but that would be one more incentive to do it.

Mrs. KENNELLY. But debatable still?

Mr. McINTYRE. Well, it would clearly be an incentive to do it. How much impact it would have would be the debate.

Mrs. KENNELLY. Thank you, Mr. McIntyre.

Mr. Rahn, obviously capital gains has been debated ad infinitum. I just came in quickly at the end of Mr. Rangel's remarks. And we've had the Dear Colleagues, and we've had the differences in estimates between Joint Tax and Treasury.

But can you give me an example in everyday life why our economy is suffering or souring because in fact we did change the capital gains rate. Not that we'll unleash, you know, further investment down the line that will increase savings, just an everyday example of where today the economy is souring because we did change that rate?

Mr. RAHN. We haven't had a long enough period of time since the 1986 changes, I think, to have enough empirical data to really show, I think, the kind of economic destruction that ultimately will prevail from those higher rates.

But we do have the experience of going back. In the sixties, we had a maximum capital gains rate of 25 percent. Over—starting in 1969 and throughout the seventies, we increased that until we got up to a maximum rate of 49.125 percent. It was quite clear that, by the late 1970's, that venture capital had dried up in this country; that many new ventures were moving elsewhere.

I remember in the 1978 capital gains debate very well how Ed Shaw, who subsequently became a Member of the Congress, who had been a California entrepreneur, came in to make the case that he had to go to Japan to get the venture capital because it had so dried up in this country.

It was clear that once we reduced those rates in 1978 that we had a revitalization of venture capital, the economy began to perk up. We increased revenues to the Federal Government, and we also eliminated much of the unfairness of just taxing inflation.

Given all those benefits, I think that it's clear that the rate ought to be lower than it is now. Good economists can have good debates over what the revenue maximizing rate is. Again I've seen studies that I thought were reasonable, going from 9 percent to 26 percent. When you're in doubt, you normally want to go with a lower rate rather than a higher rate.

I agreed with the administration's notion of 15 percent. I know people at the Treasury had debates between 15 and 20 percent. They couldn't isolate exactly the point to maximize the revenue.

But it was clear that you have all these side benefits. It's also clear that a very large portion of capital gains, particularly at the high rates, comes just off inflation. I don't know anybody who really defends that.

Mrs. **Kennelly**. Well, let me just go back to you, how you started out.

Since we don't have, and I guess you're right, any empirical evidence, because it has only been a couple of years since the 1986 tax reform, doesn't that mean that you kind of agree with our chairman, that we should give the changes that we made in 1986 a little more time so we can get better evidence whether they're working or not?

Mr. **Rahn**. Well, no, because I have no doubt that we will see the destructive evidence in the way we did in the 1970's. We've got enough historical experience with capital gains rates, of raising them and lowering them over a long enough period of time to know the consequences.

I agree with your chairman essentially that we ought not to open up the code in a massive way again, get back into all the rates.

But some things, I think, are sufficiently self-evident. And we have enough empirical evidence from past time periods and from studies that have been done to demonstrate that what we're doing now with capital gains ultimately will lead us into greater difficulty.

And 2 or 3 years from now, when we have more data in, I have no doubt that we will show both lower revenues, a low rate of new ventures in capital formation than we otherwise would have had. So it's sort of taking the preventive medicine before the patient is in a coma.

Mrs. **Kennelly**. The only problem with that is that so many people in the Congress say if we are going to lower capital gains then we should increase marginal rates.

Mr. **Rahn**. Sure.

Mrs. **Kennelly**. It has almost become a quid pro quo in the vernacular.

Mr. **Rahn**. I think there's no reason for that quid pro quo. I know that's often stated.

There are a lot of ways to approach the capital gains problem. We have very serious debates at the chamber of the correct way to do it, and also realizing the revenue constraints, that you want to make sure that any change you make is at minimum revenue neutral and ideally a revenue gain, we understand that.

When you get into debates about exclusions and indexing and all the possible combinations, there's no one right answer. But I think there is more of a common agreement where we are now without either an exclusion or any indexing will be shown to be counterproductive and unfair over the long run.

Mrs. **KENNELLY**. Thank you, gentlemen, both.

Mr. McIntyre.

Mr. **McINTYRE**. Mrs. Kennelly, I just wanted to make a point about the 1970's. It's a humorous thing, I guess, being on the committee, to hear an industry come in and say, "we need a tax break to exist." Yet this happened in 1978. The venture capital industry came in and said "we don't exist because capital gains taxes are too high, but we will exist if you cut the tax."

Of course they did exist. That's how they were able to form a lobby. They had been doing quite well since the mid-1970's when the electronics industry took off.

They did well after 1978, as well, in attracting money from pension funds primarily, which are tax-exempt, and always have been tax-exempt. But the thing to keep in mind is that usually the lobbyists who come before the committee asking for something want you to give them a break for what they are already doing, not for something that they will do in the future.

Mrs. **KENNELLY**. Thank you, Mr. McIntyre. Thank you, gentlemen.

Thank you, Mr. Chairman.

Mr. **ANDREWS** [presiding]. Mr. Moody.

Mr. **MOODY**. Thank you.

Mr. Rahn, you say in your testimony that the most antigrowth policy that Congress could pursue would be to raise taxes.

Mr. **RAHN**. Yes.

Mr. **MOODY**. I remember one interesting definition of taxes in my public finance courses was that taxes were not to finance government because government can be financed any way you want. You can borrow money or you can print money.

But the purpose of taxation is to restrain personal consumption. Because personal consumption can be government consumption on an available resource.

If we are entering an inflationary phase—we might be, and we're all worried about that—perhaps long-term growth would be assisted by taxation, be it VAT or any tax that soaks up consumption.

Mr. **RAHN**. I have two responses to that.

First of all, I'm much more worried about us going into a recession than I am inflation at the moment. I think the Federal Reserve has been overly tight. We see very marked slowdowns in our economy.

Mr. **MOODY**. By the way, they're being overly tight because they're worried precisely about inflation.

Mr. **RAHN**. Pardon me?

Mr. **MOODY**. They're being overly tight because they're worried about inflation.

Mr. **RAHN**. Yes. But——

Mr. **MOODY**. If there were other policy instruments to head off inflation, maybe they wouldn't be.

Mr. RAHN. Probably today isn't the day to get into a long run monetary policy. But the inflation comes from a rapid monetary growth in 1986, which they are trying to overly compensate now for. But the problem is that might put you into a recession, and a lot of people suffer in a recession, and they've had relatively slow monetary growth in 1987 and 1988, which means there's not the kind of inflationary potential out there that we had in the 1970's.

Mr. MOODY. You disagree with their analysis?

Mr. RAHN. I disagree with their analysis.

Mr. MOODY. OK. If you did, however, you would concede my point?

Mr. RAHN. No.

Mr. MOODY. There was a study done last year by the Treasury Department which shows that, with any tax increase, even those in consumption, about 80 percent comes out of savings.

We get into what we call a permanent consumption hypothesis where people get used to a certain level of consumption. What they do is alter their savings up and down which changes income or taxation much more so than they do consumption. That's the short-run effect.

Over the long run, it gets back to normal. But we have also found that typically most tax bills going to the Congress have come more out of savings investments they have consumption. And rather than restrain the growth——

Mr. RAHN. I was only responding, reacting to your statement, which did not distinguish. You just said taxes in general. But you're modifying your statement to say taxes that are based on savings are take away——

Mr. MOODY. Well, if you take it out of savings, if you have a tax on savings, that becomes very destructive over time. There's just less capital formation, particularly because we know that Congress tends to spend any tax increase. There's been a lot of testimony before this committee and others of how when Congress has increased taxes, spending has gone up rather than down, which is why deficits went up.

Mr. RAHN. Just hold that. That's a new discussion. Let me focus on what you're saying.

Income taxes don't come mostly out of savings; income taxes come, precisely, mostly out of consumption for the very reason you just mentioned, that 80 percent of the taxes come out of consumption. You said taxes——

Mr. MOODY. I thought I said 80 percent of a new tax will come out of savings, not consumption.

Mr. RAHN. If you put a new tax on the typical American, about 80 percent of that tax initially will come out of their savings.

Mr. MOODY. I see.

Mr. RAHN. Rather than their consumption.

Mr. MOODY. Short term, short term.

Mr. RAHN. Yes. And depending on the type of tax, over the longer term, it gets back to their normal propensity for consumer saving.

Mr. MOODY. When we are talking about growth, we're talking longer term, we're not talking about the front end any more than we would talk about only the front end on capital gains. We obviously have to look at longer term.

Mr. **Rahn**. The only way that the Government could tax individuals to a point where it could speed up economic growth, is if the tax was largely on consumption and the Government put the revenues in productive investment. Except most increases in Government spending are on transfer payments which doesn't add anything at all to productive capital.

Mr. **Moody**. My second point of this question is, and you brought up monetary policy, obviously if we—if Government—if personal consumption can stick you downward, so can Government consumption stick you downward. You know how tough it is around here to cut programs, and I was interested to see that you yourself don't suggest restraining Social Security in your own recommendations—half of the budget's entitlements. The Reagan budgets have received only a handful of votes on either side of the aisle when they were put on the floor of the Senate and the House, so it's going to be very tough to cut below some levels, as much as we might want to.

Given that fact, isn't the real question is do we finance that spending by taxes at the margin, or by borrowing at the margin, and, sir, we have been financing it by borrowing. So the most antigrowth thing we can do, it seems to me, is to continue to borrow because of the monetary mechanism of interest rates, borrowing. I assume you concede that massive Government borrowing, that now is approximately two-thirds of the private savings does affect interest rates upward.

So I think the tradeoff has to be, if we finance Government, that politically possible level of Government, by borrowing or do we finance it by taxes, which hurts growth more?

I think it's an open argument because I think interest rate increases are also very harmful to growth.

Mr. **Rahn**. Well, there's no consensus, as you know, in the economic profession, whether you're better off with more borrowing or more taxes. But I think what is clear is that tax revenues now, out of the tax system you people have put in place, are increasing Government revenues about 8 percent per year. Inflation is roughly 4, 4½ percent.

So, as long as you allow spending to only increase a bit faster than inflation, I'd say about 5 percent, the deficit will come down both in real and nominal terms.

Mr. **Moody**. Right.

Mr. **Rahn**. We can debate about the year.

Mr. **Moody**. But I'm talking about the rate of the reduction of the deficit. It may be more important to do it faster than that.

Mr. **Rahn**. But it appears to me also that the empirical evidence is rather overwhelming when we've had tax increases that slow the economy and Congress has spent the additional money—I go back to the TEFRA tax increase.

Mr. **Dorgan**. Would the gentleman yield?

Mr. **Moody**. Yes; sure.

Mr. **Dorgan**. Can I just observe that the deficit, Mr. Rahn, is not getting better, it's getting worse. A $92 billion predicted deficit is really $180 to $190 billion because they're computing $68 billion in

Social Security surpluses, and phony estimates of 3-percent interest rates in 1993.

The only point I want to make is that when economists tell us just wait around, things are getting better, it's sort of like Ronald Reagan saying things are getting better. They are not getting better.

An honest evaluation of today's deficit is that the deficit is not improving.

Mr. RAHN. The deficit as a percentage of GNP has fallen. If you look at the total Government debt in public hands as a percentage of GNP, it is no longer rising.

Ideally, you want smaller deficits rather than larger deficits. But when you're talking about a deficit reduction medicine, you have to see if the medicine is worse than the disease. Most of the medicines I have seen on the tax increase side clearly are worse than the disease.

Mr. MOODY. Let me just wind up by saying that I don't think we're in a situation any longer where we simply go out and spend every marginal dollar that we raise. I think the real question now is how fast do we want the deficit to come down, and whether it is better to borrow as we go along, or at the margin to tax?

I don't think that you can make the clear statement that you did that the worst thing we can do is finance that extra level of Government by taxing.

Mr. RAHN. My judgment, after looking at this for a number of years, is that borrowing is less destructive than an increase in taxation. I prefer less borrowing, however.

Mr. ANDREWS. The gentleman from Georgia will inquire.

Mr. JENKINS. Thank you. Mr. Chairman, I only have one question.

Mr. McIntyre, I see from your statement dealing with R&D tax credit that you indicated that Professor Mansfield had done a study indicating only modest benefits from the R&D tax credit.

Are you familiar with other studies dealing with that R&D tax credit?

Mr. McINTYRE. I've seen others. They've been criticized, mainly on definitional grounds. There has been obviously an incentive to recharacterize items such as R&D. You know, they say if you go down to fix the boiler and you succeed, it's repairs, and if you fail it's R&D.

Mr. JENKINS. Have you read the tax study that was done at Brookings between 1981 and 1985 that concluded that between 1981 and 1985, the R&D tax credit increased R&D by 7 percent more than would have been the case without it, and that the GNP would be between $20 and $31 billion higher in 1991 as a result? This was almost twice the rate of R&D increases in 1960 through 1975.

Do you discount those studies?

Mr. McINTYRE. I think they are less persuasive when you look at the details, yes.

Mr. JENKINS. I looked at that study, and I don't know exactly what you mean.

Why is it less persuasive?

Mr. McINTYRE. Well, one of the problems with this kind of work is trying to figure out what the baseline is to compare it with.

Mansfield's approach was to try to ask the companies, some of the other studies make up their own baseline. I don't mean make it up in any bad sense, but they have to choose it. And that's where the problems come in.

Mr. **Jenkins**. Well, each of the studies that I have seen, including the one that you have alluded to, indicates an increase in benefits from the R&D tax credit.

Mr. **McIntyre**. Right. The question is whether it's worth the money that it costs the Government.

Mr. **Jenkins**. Thank you.

Mr. **Andrews**. Mr. Sundquist.

Mr. **Sundquist**. Thank you, Mr. Chairman.

Mr. McIntyre, as I sit here and listen, it seems to me that the net result of your testimony is that we're going to continue to lose jobs if we follow your economic advice.

How do you respond to the tables that show that Germany, Italy, the Netherlands, Belgium, Hong Kong, Taiwan, South Korea, and Singapore, et cetera, all of them exempt long-term capital gains from taxation? Japan's at 5 percent. I would think you would be particularly interested in this, that the Socialist Governments of France and Sweden have low capital gains.

How do you respond to that?

Mr. **McIntyre**. Well, I think it is important to note that we had very low capital gains taxes in the past, and those are the periods when we built up the big trade deficits and set the policies in line that led to high interest rates.

Mr. **Sundquist**. That's not true.

Mr. **McIntyre**. Since we have raised the capital gains tax to the same as another income, the trade deficit has come down somewhat.

Mr. **Sundquist**. We didn't have trade deficits in the sixties, did we?

Mr. **McIntyre**. I'm talking about during the eighties when we cut the rate to the lowest level we've ever had it. There was a promise then, if you may recall, that we would have a flood of venture capital from taxable investors. Instead, it went down from taxable investors. That we would have a booming international competitiveness and, instead, of course, with the big budget deficits that followed from the supply side policies, we ended up with the biggest trade deficits we ever had.

We now face a problem, as you know, where our children have to pay off a huge foreign debt. I for one am very angry with the people who put those policies into place in the early eighties, because I have children.

Mr. **Sundquist**. I'm angry with the people who don't want to create jobs. I'm angry with the people who would want a leveling in this country, where people can't succeed.

Mr. Rahn, would you like to comment on that?

Mr. **Rahn**. It is hard to know where to begin. The trade deficit and capital gains taxes, I never knew anybody could make any relationship between those two.

I find it rather strange when we're told that it's our budget deficit that causes the trade deficit. The British just went into a big budget surplus and what happened, suddenly their budget deficit got real bad.

Back in 1980, we were told that we were in permanent stagflation. In 1981, it was the testimony before this committee by many of the witnesses on the left side, and we were told that the tax cuts would be wildly inflationary. In 1982, we were told the tax cuts would prevent a recovery from recurring. In 1983, we were told the tax cuts and the deficits would abort the recovery. In 1984, we were told that the deficit was responsible for the rise in the value of the dollar. In 1985, we were told the deficit would prevent the dollar from ever falling. And by 1986, we were at the point, or 1987, that the deficit was responsible for the fall of the value of the dollar.

I see all these endless inconsistencies in the argument. Those people, and you look back at who projected what would happen when you reduced the capital gains taxes in terms of revenue, there was a group of us who said both in 1978 and 1981 that the tax revenues from lower capital gains taxes would increase. There was a group who said, including some of the official committees of this Congress, that said the revenues would fall. We've projected out, year by year, what would happen.

Well, the data is unambiguously clear. The people who advocated lower capital gains taxes were much closer to the mark in terms of revenue to those people who advocated higher taxes.

Clearly, we had a big spurt in venture capital. We've had record levels of job creation. Again, looking at the data, I don't know how anybody can't say that the capital gains tax rate reductions of 1978 and 1981 were not an unambiguous success, and particularly benefited the people at the bottom of the income scale.

Mr. SUNDQUIST. Thank you, Mr. Rahn.

One final comment, Mr. McIntyre, and I'm out of time, but I would like to ask you a question. Do you think that or not think that the level of capital gains taxation is a part of the cost of capital? That is the one question that you can respond to later.

Second, I would like to see more numbers from you as to why we should discourage R&D investment, as my colleague from Georgia said earlier. It seems to me that it has been successful. If we are going to try to create jobs for your members, it seems to me that we ought to be encouraging more R&D. It seems to me that we ought to be concerned about the cost of capital and creating jobs. You can respond later.

I appreciate it, Mr. Chairman. Thank you.

[Responses by Robert S. McIntyre to Mr. Sundquist's questions, follow:]

Since most corporate capital investment is financed with retained earnings and borrowed money, since most capital gains that would be affected by President Bush's tax cut proposal involve existing corporate stock and since the primary sources of venture capital investments are pension funds and other tax-exempt or quasi-tax-exempt organizations, I would conclude that the level of capital gains taxation has almost nothing to do with the cost of capital—with two major exceptions. First of all, a cut in the capital gains tax, by reducing government revenues, would increase the federal budget deficit. This would translate into higher interest rates, and thereby increase the cost of capital. Second, reinstitution of the capital gains loophole would rekindle the tax shelter industry, thereby diverting some investment into unproductive activities, and again, raising the cost of capital for productive investments.

I do not believe that the government should discourage R&D investment. I do conclude, however, that attempts to augment the existing tax incentives for R&D would be counterproductive. The cost of such new tax breaks would increase the budget deficit, and consequently the trade deficit. The result would be to harm American manufacturers, and potentially reduce R&D investments. Moreover, the administration's proposal to give larger foreign tax credits to companies that perform R&D in the United States to support foreign manufacturing and sales would create a perverse incentive to move manufacturing jobs overseas.

Mr. ANDREWS. The gentleman from Texas will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Rahn, when the administration testified before our committee on capital gains, it estimated that we would make a profit over a period of time, some 6 years, of about $9 billion.

The Joint Tax Committee has estimated that the loss, over the same period of time, would be about $24 billion.

What are we to believe? Do you have a position on that?

Mr. RAHN. Well, I have a position. I think the Treasury studies are much closer to the mark.

I go back again to what the Joint Tax Committee said in 1978 and 1981, and they were wrong both times. The direction was wrong.

None of us know precisely where the taxes change like that, how much revenue will come in or won't. But I know something about the Treasury model that was used in their last study, which took in a number of behavioral effects. It was not a static revenue model. The problem is that many of the official models, for too long, had been largely static revenue models where they put in very modest, if any, behavioral effects.

We know that the capital gains tax is a largely discretionary tax, and behavioral effects are extremely important.

Mr. PICKLE. Admittedly, we may have to just make an arbitrary decision on whether it would be a profit and loss and what amount.

But as one who favors the differential on capital gains, I need to know a little bit more with certainty about the estimate. When you've got a disparity between $9 million plus and $24 billion lost, I hesitate to move forward until something is settled.

Do you know whether the administration and our committee are attempting to resolve those differences and see if we can have a better understanding as to the cost they're causing?

Mr. RAHN. I know that people at Treasury and within the Administration are working to try to make their revenue numbers as precise as possible and do a better and better job.

Mr. PICKLE. I would say to you and to business and to the Administration, if they're here, that they ought to help us resolve these numbers or else many of us are going to be willing to just wait it out to see what are the actual figures, the best we can tell.

Now, I understand that Secretary Brady and probably Mr. Darman are talking to our Budget Committee. They are talking to them in total numbers only I presume, but within that total number they have to make some allocation of what they estimate would be the profit and/or loss in the capital gain area.

Now, I say unless this committee is brought into that, you are going to have a difficult time convincing this committee to move forward on a capital gains proposal if we are not part of the conversations and we are not brought into the picture.

If we don't have some effort to resolve the difference, so I just say to you, who represents business, I hope you help us get some of these parties together so we can have some unanimity about what the facts are. That's not your responsibility, but you have a voice in it, and I hope you pass it on, and I hope the administration is listening.

Mr. **Rahn**. We will be happy to do what we can.

Mr. **Moody**. Would the gentleman yield for 1 second, for just 1 second?

Mr. **Pickle**. Yes; I yield briefly.

Mr. **Moody**. There's a report out by the Congressional Research Service, called the "Capital Gains Response to A Tax Rate Change." It's a dynamic analysis, it's an econometric analysis, and it's very persuasive.

Perhaps, Mr. Rahn, you'd like to respond, give your comments on this to the committee at some later point.

Mr. **Rahn**. I'd be glad to.

Mr. **Moody**. Thank you.

[The information follows:]

U.S. Chamber of Commerce

Washington, D.C. 20062

BRIEF RESPONSE TO THE CONGRESSIONAL RESEARCH SERVICE REPORT OF DONALD W. KIEFER ON CAPITAL GAINS RESPONSIVENESS TO TAX RATES

Most capital gains studies are based on actual historical data. They look at the tax rate on capital gains, the impact that changes in the tax rate have on capital gains realizations and therefore on federal revenues.

The Kiefer study is not based on actual data. It is instead based on his model which, in turn, is a function of several arbitrary, non-factual assumptions that drive his results.

He assumes that all common stocks go up at a steady rate of 7.5 percent. He assumes that the average holding period is seven years. He acknowledges in his paper that "there is little information on average holding periods of individual investors". Yet these are the two assumptions that drive his results.

His first assumption assumes a degree of investor knowledge and homogeneity in the capital market that is unwarranted and tends to reduce the degree to which assets will be traded.

His second assumption of a seven year holding period also tends to reduce the responsiveness of investors to a lower tax cost of portfolio adjustment.

The central problem with the Kiefer study, however, is that it is not based on actual experience. Instead, it is based on a highly theoretical model whose key variables have virtually no basis in fact.

Finally, the model does not take into account a host of other relevant considerations, including the positive impact that a lower capital gains tax rate would have on stock and other asset values and the positive impact that a lower capital gains rate would have on economic growth.

Mr. **Moody**. It goes exactly to your point.

Mr. **Pickle**. Let me also say to Mr. McIntyre, and this is just a statement more than a question.

As one who had taken a personal interest to advance our research and development for high technology areas primarily, I have been convinced that the credit has been very helpful. We must do something to make American business competitive on a worldwide basis. Without it, we're losing our edge in the high technology. That's why I think it's so important that the Government try to encourage it. If we don't do that, we're going to get into an area of subsidization, and that is a bad practice, and it's something we should avoid.

If we can really have a good incentive and it's working, I would think you would want to support that. I think anybody would, whether it's business or whether it's the group that you represent.

I think that what we've done in the past has been good. We are attempting to make it more effective and more meaningful. And that's why we have changed the base period so that no one can say that they're just keeping R&D lower to take advantage of the credit.

To the extent that that might be a bona fide criticism, we are trying to establish a new base period.

Now, have you looked at the new proposal and new base period? Do you have objection to that approach?

Mr. **McIntyre**. I don't think changing the base period is my basic objection. The primary problem with this, Mr. Pickle, unless this incentive is terribly effective, then it's a cost that we are going to pay for with money we borrow from Japanese investors. Therefore it is going to lead to a higher trade deficit.

As long as we are borrowing $130 or $140 billion a year from overseas, we have to run a trade deficit of that magnitude unless there is some unprecedented increase in domestic savings. Because as long as our savings deficit requires foreigners to send $140 billion here as investment, that's $140 billion that they're not buying of our exports.

It's just simple arithmetic. That's why, if we're worried about competitiveness, the absolute, No. 1 job is to increase national savings. And the way to do that is to cut the deficit.

Mr. **Andrews**. The gentleman from Florida, Mr. Shaw.

Mr. **Shaw**. Thank you.

I'm somewhat fascinated by the partisan nature of something that should be much more exact testimony, by both the witnesses and the members.

Mr. Rahn, you have made a very strong point. Correct me if I've misinterpreted you, or misunderstood you. You have said that the income producing effect of the tax is inverse to the level of taxation when we are talking about capital gains.

Is that correct?

Mr. **Rahn**. I have said that the capital gains tax now is above the point where it maximizes revenue to Government. Each different tax will have some point where it maxes out in terms of a revenue producer for Government.

Empirical evidence for the capital gains evidence is rather overwhelming, it is now too high to even maximize revenue for Government.

Mr. SHAW. Did I understand you to say that in every instance where the capital gains rate has been dropped to make it more attractive to investment in capital asset, that the net effect has been increased revenue to the Federal Government?

Mr. RAHN. Yes. Well, in the 1978 and 1981 acts, where there are two recent experiences in dropping it, and during the 1970's when we kept increasing it, the revenues from the tax did not go up.

Mr. SHAW. That should be at a very exact figure.

Mr. McIntyre, do you disagree with that?

Mr. McINTYRE. Totally, Mr. Shaw.

Mr. SHAW. Would you specifically tell me how and where you disagree with that rationale? I am not talking about theory. I am talking about practice.

Mr. McINTYRE. Well, in practice, yes. After 1978, we increased capital gains realizations, which had begun before 1978, but continued, basically tracking the stock market's growth. There's a graph in our testimony that shows that the tracking is almost identical. In other words, when the stock market goes up, people have more capital gains.

In addition, Mr. Rahn appears to be taking credit for the boom in tax shelters, many of which led the increased gains.

Tax shelters do not raise revenues, Mr. Shaw; they lose revenues.

Mr. SHAW. Wait a minute. Let me interrupt you, Mr. McIntyre. This is my questioning period, and I want to be sure you address the issue that I have addressed.

Do you dispute the remarks as to what Mr. Rahn said to you. Have you found decreased revenue to the Government as a result of giving more favorable capital gains rate, and if you do, would you please cite that example with specificity to the committee?

Mr. McINTYRE. Do I think that cutting capital gains taxes——

Mr. SHAW. I didn't ask you what you felt. You've made that very clear.

I'm asking you can you cite an example where cutting capital gains rate resulted in less revenue to the Federal Government?

Mr. McINTYRE. Well, the times that it was cut were 1978 and 1981, so those are the examples, if that's what you mean.

Mr. RAHN. If I can interrupt, I have a table here which is from the U.S. Treasury Department, showing revenues and rates since 1968 through 1986. As an example, in 1978, the last year before the rate was cut, the rate at that point, the maximum rate was 49.125 percent, the revenue was $9.1 billion.

In 1979, we dropped the rate to 28 percent, the revenue went up to $11.7 billion.

In 1981 or 1982, we dropped the rate to 20 percent, the revenue went up to $12.9 billion. And by 1986, the revenue was at $46.4 billion at a 20-percent rate.

Now, you can go back and just look at the empirical evidence of rates and revenue over time, and it's rather unambiguously clear.

Mr. SHAW. Now, could I ask you to show that table to the gentleman next to you, Mr. McIntyre?

Mr. McINTYRE. I'm familiar with the numbers, Mr. Shaw.

Mr. **Shaw**. Well, do you disagree with the numbers?

Mr. **McIntyre**. No.

Mr. **Shaw**. Fine. Could I ask, if that table is not in the record, that it be made part of the record?

[The table referred to follows:]

REALIZED CAPITAL GAINS AND THE ASSOCIATED REVENUE

Year	Capital Gains ($ billions)	Revenues ($ billions)	Top Marginal Tax Rate On Capital Gains**
1968	35.6	5.9	26.9%
1969	31.5	5.3	27.5
1970	20.8	3.2	32.3
1971	28.3	4.4	38.8
1972	35.9	5.7	45.5
1973	35.8	5.4	45.5
1974	30.2	4.3	45.5
1975	30.9	4.5	45.5
1976	39.5	6.6	49.1
1977	45.3	8.1	49.1
1978	50.5	9.1	48.3
1979	73.4	11.7	28.0
1980	74.1	12.5	28.0
1981	80.9	12.7	23.7
1982	90.1	12.9	20.0
1983	122.0	18.5	20.0
1984	138.7	21.5	20.0
1985	168.6	24.5	20.0
1986	319.3	46.4*	20.0

1968-1982 data are from the Office of Tax Analysis, "Report to the Congress on the Capital Gains Tax Reductions of 1978," p.154. 1983-1984 data are from the Statistics of Income, with revenue calculated using information from the tables in those volumes.

* 1986 Realizations figures based on preliminary IRS data; revenue figure is based on assumption that 1985 effective rate is correct; given stability of effective rate of about 14-16 percent that assumption should not be too wrong.

** Rates compiled by Congressional Budget Office, based on data from the Office of Tax Analysis, Department of Treasury.

Mr. **Rahn**. It's in my testimony, Mr. Shaw. The evidence on capital gains realization is in my testimony.

Mr. **Shaw**. All right. Can I ask——

Mr. **McIntyre**. It correlates with things other than capital gains taxes.

Mr. **Shaw**. What worries me is the fact that there is not a shred of evidence—and I'm not talking about theory here. We have got decades of experience with tax rates to look at. Either it does or it does not produce revenue. There certainly should be a simpler way to do it.

Now, I find myself usually in disagreement with many economists, because I am more of a CPA in persuasion. I think Mr. Rahn has made a very concrete case with specific examples of historical data which proves his case.

Mr. **McIntyre**. Well, you see, revenues also went up after the capital gains tax was raised.

Mr. **Shaw**. Excuse me. You have totally failed to give us an example of how lowering of the capital gains rate has produced a net loss of revenue to the Federal Government. I think that is what this committee is trying to sink its teeth into.

I yield back, Mr. Chairman.

Mr. **Andrews**. Thank you, Mr. Shaw.

This concludes the questioning of this panel. I would like to dismiss this panel and ask the second panel on energy tax incentives to please take their places.

We are going to adjourn for about 10 minutes to conclude the vote that is presently in Congress and presently being called. Then we will come back and reconvene in about 10 minutes. It's 11:30 now, so by 11:40, 11:45, we'll start again.

[Recess.]

Mr. **Andrews** [presiding]. I call the committee back to order, please, and ask the second panel to please take their seats.

In this panel we have with us today from the Independent Petroleum Association of America, George Singer. From the Petroleum Equipment Suppliers Association, James Woods. From API, the American Petroleum Institute, Charles DiBona. From the California Independent Petroleum Association, James C. Hall.

I would like to ask all of you—we have your written testimony—please take the time you need to give us your thoughts about this situation.

Mr. **Singer**. Shall we start?

Mr. **Andrews**. Go ahead.

STATEMENT OF GEORGE A. SINGER, PARTNER, SINGER BROS., TULSA, OK, AND CHAIRMAN, TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. **Singer**. Thank you, Mr. Chairman. Mr. Chairman, and members of the committee, my name is George Singer. I am a partner in Singer Bros. of Tulsa, OK, an oil and natural gas exploration and production company.

I appear here today as chairman of the tax committee of the Independent Petroleum Association, which is the national association representing the nearly 10,000 independent crude oil and natural gas exploration and production companies in all 33 States with oil and gas production.

Mr. Chairman, we are very pleased that these hearings are being held, and that you have set aside an entire panel for discussions on energy incentives.

Independent oil and natural gas producers are the backbone of the domestic energy industry. We drill nearly 85 percent of all wells in the United States. We produce 33 percent of all the crude oil, and 60 percent of all natural gas in the United States. Yet our business is a high-risk activity.

For instance, in 1988, 76 percent of exploratory wildcat wells were dry holes. Drilling for oil and natural gas is not an exact science, and it is extremely capital-intensive. Moreover, an exploration venture is not something which one can take to the bank for collateral.

We are dependent upon investment capital. Our own funds are limited. We only have one source of revenue, wellhead revenue. We cannot make up for upstream losses with downstream profits, or vice-versa.

The Government does not guarantee us a price support for our commodity nor does the Government provide low-interest loans for wildcatters. Simply put, we live and die at the wellhead.

When wellhead revenue decreases, we have less income to reinvest and our ability to attract new investment capital for exploration is impaired. Independents have been devastated both by the collapse of oil and natural gas prices, and a total absence of investment capital. Our ranks are thinning.

The rig count, which was once over 4,500, is currently below 800. U.S. production is down and demand is up. The future is not promising for independents as long as our Government allows OPEC, and the emotions of tragic accidents to dictate our Nation's energy policy.

Congress and the administration can and should regain control of our energy policy for the sake of our Nation's economic stability, our international competitiveness, and our national security.

In his budget for fiscal year 1990, President Bush has proposed a set of tax incentives for independents to find new oil and natural gas fields, and reclaim old fields.

We applaud the President for his recognition of the critical role played by independents. His stated principles are sound and his policies are a step in the right direction.

However, we believe the President's proposals are too narrow in scope to effectively arrest the decline in exploration and production of oil and natural gas. The skeleton is there but it needs some meat and muscle.

We strongly prefer the Domestic Energy Security Act, H.R. 664, and the Energy Security Incentive Act, H.R. 658.

IPAA has worked closely Mr. Andrews, with Congressman Archer, with Congressman Pickle, and with Congressman Thomas in crafting these bills.

The bills are similar in nature, and represent the best opportunity we have, given today's political realities, of putting independents back on their feet, and helping this Nation regain control of its energy security.

Mr. Chairman, I wish to take this opportunity to recognize the skilled leadership of yourself and Congressman Archer, and your staffs. We are indebted to their efforts, and to the support of friends like Congressman Pickle and Congressman Thomas.

In closing, Mr. Chairman, we recognize that a sound energy policy must coincide with a sound budget policy, and we are ready to work with the committee to bring that about.

Again, thank you for this opportunity to appear before the committee.

[The statement of Mr. Singer follows:]

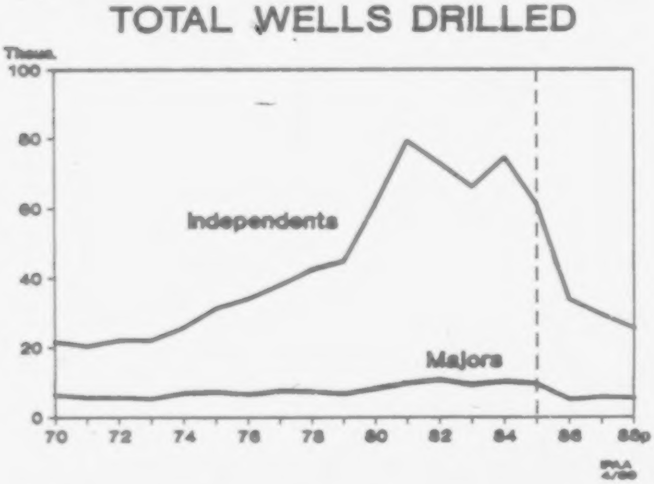
Statement of
the
Independent Petroleum Association of America
before the
House Ways and Means Committee
Hearing on Revenue Proposals
Contained in the President's Budget for Fiscal Year 1990
April 12, 1989

My name is George Singer, I am a partner in Singer Bros. of Tulsa, Oklahoma, an oil and natural gas exploration and production company. I appear here today as Chairman of the Tax Committee of the Independent Petroleum Association of America, the national association representing the nearly 10,000 independent crude oil and natural gas producer/explorers in all 33 states with oil and natural gas production.

In considering the prospects for future development of U.S. petroleum resources, it is important to recognize the separate and very different roles of independent oil and natural gas producers as compared to major integrated companies. Also important is a proper understanding of the industry's ability to respond to changing economic conditions, as illustrated by events in the 1970s and 1980s.

Role of Independents

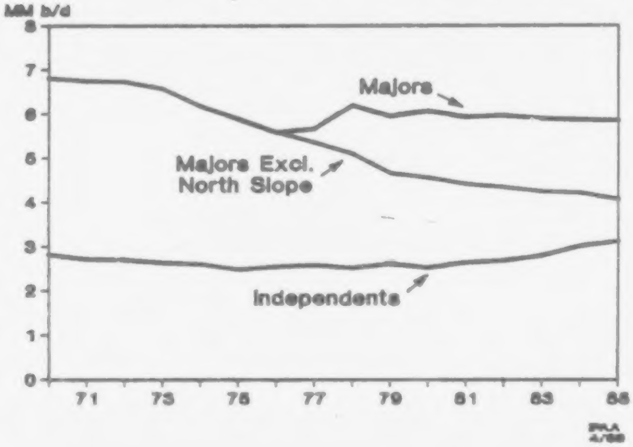
Historically, independents have accounted for more than 85 percent of all wells drilled, both onshore and offshore, in the "lower 48" and Alaska.



Major companies, because of their size, capital structure, and overhead, concentrate on the larger prospects, mostly offshore and in Alaska, which result in finding substantially greater reserves and higher per well production. Independents, on the other hand, can profitably operate properties with much lower reserves and daily per well production. The majors add average new production of 60 barrels per day (b/d) for each new well, compared to the independents' 12 b/d. However, the significantly larger number of wells completed by the independents more than overcomes the smaller quantity added per well. Thus, while the larger companies may be more efficient "statistically", they do not drill enough wells to offset the current U.S. production decline.

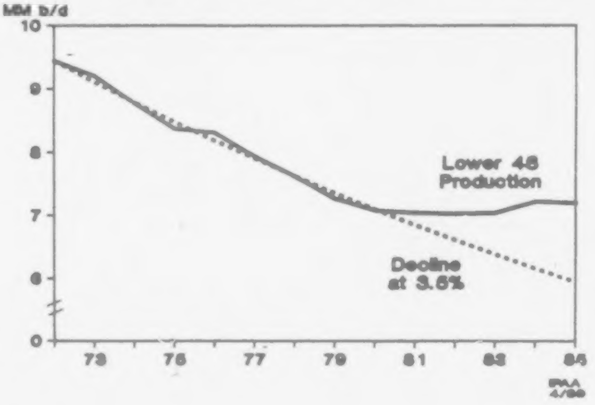
Excluding Alaska North Slope production, the independents' share of domestic production increased from 29 percent in 1973, to 44 percent in 1985. During this period, production by the major integrated companies declined more than 2.5 million b/d. The larger discoveries by the majors are vital to overall U.S. energy supply. But it is the small, daily production additions and the maintenance of marginal wells by the independents operating onshore in the "lower 48" that historically have been the "backbone" of domestic oil and natural gas production.

U.S. CRUDE OIL PRODUCTION



The impact that independents can have on U.S. production levels is dramatically illustrated in the six-year historical period ending in 1984. During this period, independents drilled 202,652 new oil and natural gas wells, an increase of 155 percent when compared to the six years following the peak production year of 1970. As a result of independent drilling activity, not only was the production decline arrested, it was reversed. The U.S. experienced a six-year production increase. To some, the increase may seem modest. However, when compared to the level that U.S. production would have reached absent this increased drilling activity, this reversal is dramatic. U.S. production would have been 1.3 million b/d less in 1984 (and our cost for imported oil almost $15 billion greater) had the downward trend of the 1970's continued.

LOWER 48 CRUDE OIL PRODUCTION



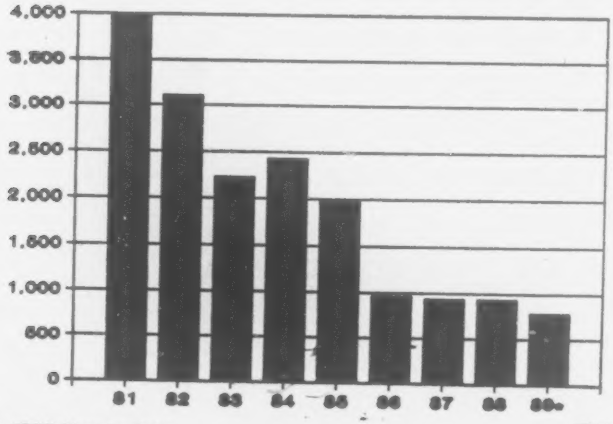
State of the Industry

The supply manipulations by foreign governments and the resulting price fluctuations have devastated drillers, independent oil producers and oil field service companies. Independent producers, in particular, continue to take a terrible beating. The economic devastation of the independent sector has resulted in a serious and dramatic fall in U.S. production. U.S. crude oil production began to fall in 1986, reversing a four-year upward trend. This decline has continued, with 1988 annual average production falling to 8.1 million barrels per day, the lowest output since 1976. Production in the lower 48 states already has dropped to levels not experienced since the early 1950s. In Texas, 1988 crude oil production sank to the lowest level in 45 years prompting Texas Railroad Commissioner Jim Nuggent to say: "The evidence of our decline has been constantly before us over the last few years, written in the rust of stacked drilling rigs and the ledgers of the state's bankruptcy courts." Production declines are expected to continue until drilling increases to 80,000 wells per year. (Total wells drilled in 1988 was around 31,000).

The impact that drilling activity has on production levels is not felt immediately. There is a 2 to 2 1/2-year lag between changes in drilling rig utilization and its affect on production levels. Thus, we have not seen the full impact that the dramatic decline in drilling activity will have on production levels which began in 1986.

A good indicator of the health of the domestic oil and natural gas industry is drilling rig utilization. It is activity by independents which, to a great extent, drives the domestic drilling rig count either up or down. It is the utilization, or lack thereof, of drilling rigs which in turn fuels the infrastructure of domestic exploration and production--the service and supply sector, equipment and materials manufacturers, and related financial and technological activity. These activities provide hundreds of thousands jobs throughout the U.S., not just in oil and natural gas producing states. The peak year for rig utilization was 1981, when an average 3,970 drilling rigs were at work. In 1988, the average number of rigs remained at 936 for a second year in a row. To date in 1989, the average is 796.

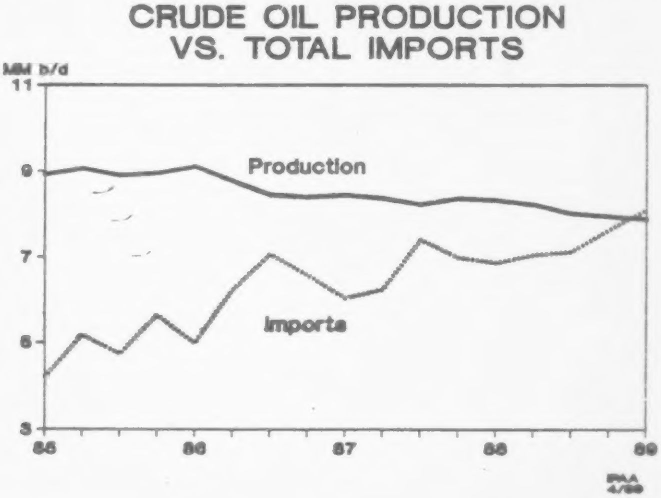
AVERAGE ROTARY RIG COUNT



* 1989 Year-to-Date

IPAA
4/89

At a time when U.S. sources of oil are diminishing due to a lack of exploration activity, U.S. and world oil demand is rising. And there is little or no growth in non-OPEC sources of production. In fact it is anticipated that non-OPEC sources of oil production will decline in the near future. This means that current and future additional demand for oil is being met largely by OPEC countries, particularly by the large producing states in the Persian Gulf. U.S. petroleum imports rose 8.5 percent in 1988, to an annual average of 7.2 million b/d. Imports as a percent of domestic supply increased to 40 percent last year, compared to a 38 percent ratio in 1987, and a 30 percent ratio in 1985. The value of U.S. petroleum imports reached almost $40 billion last year, and this is in the context of low prices.



The implications of increased oil imports to the national security of the United States has been evaluated in recent studies conducted by the U.S. Departments of Energy and Commerce. Each study concludes that the U.S. access to sufficient supplies of petroleum is essential to the U.S. economic security, foreign policy flexibility, and defense preparedness. Consequently, it ~~was found that petroleum imports threaten~~ to impair our national security. Each report recognizes that there are a variety of government options available to respond to the rising levels of imports, including increased energy efficiency and greater fuel substitution. The reports also recognize that conservation and fuel substitution alone are insufficient to limit dependence on oil imports and the vulnerability which is inherent in that dependence. In addition, a strong domestic energy industry must be maintained.

The U.S. Department of Commerce stated, "the best means to enhance U.S energy security is to increase opportunities for economic energy production and to ensure that adequate oil supplies are available in the event of a supply disruption."

And, the Department of Energy stated, "Even with continued conservation and efficiency and substantial contributions from other energy resources, like coal, nuclear energy and renewables, our economic and energy security is inextricably tied to the fate and fortunes of our domestic petroleum industry through this century."

In addition, the General Accounting Office last year urged Congress to give the U.S. oil industry a stable financial framework. The GAO said Congress should maintain "a stable economic and regulatory atmosphere" that encourages investments in oil and alternative energy programs.

In order to insure adequate domestic supplies of energy during cyclical declines in energy prices, the Departments of Energy and Commerce recommended direct tax incentives to boost domestic oil activity. Some of the more desirable direct tax incentives, according to the DOE study, include the following: (1) provide tax credits for exploration and development, (2) allow for a faster recovery of geological and geophysical costs, (3) increase statutory depletion on new production, (4) raise statutory depletion for independents, (5) increase the net-income limitations for the statutory depletion deduction, ard, (6) repeal the "transfer rule" for statutory depletion.

President Bush's Energy Incentives

The President's tax proposals generally follow those proposed by the DOE; that is, tax credits for oil and natural gas exploration and tertiary recovery, modification of the oil and natural gas depletion rules, and alternative minimum tax relief. IPAA applauds the President's recommendations as a long overdue step in the right direction in establishing a national energy policy--a policy which recognizes the national need for a viable domestic energy industry.

Tax Credits

The IPAA strongly supports the idea of tax credits to enhance the economics of oil and natural gas exploration. It is the number one policy recommendation of the IPAA's tax committee. Tax credits are important to independents for one primary reason--capital formation.

Oil and natural gas exploration and development is extremely capital intensive and very high risk. Obtaining sources of financing for new ventures is difficult, if not impossible, due to continued price uncertainties. We welcome the President's proposal on oil and natural gas tax credits, but we feel that his proposal does not go far enough to sufficiently aid in the recovery of the domestic oil and natural gas industry--in particular the independent sector. On the President's proposal for a 10 percent credit on the first $10 million of exploratory intangible drilling costs and a 5 percent credit thereafter, we offer the following comments:

o We feel strongly that the credit should apply to more than exploratory drilling. The credit should be expanded to include development drilling as well. Not only are there are myriad definitional problems in limiting the credit strictly to exploratory drilling, but development drilling will provide the U.S. with new reserves to offset rising imports much more quickly and dramatically than exploratory drilling. Such development activity currently is not taking place because the sources of capital to finance development drilling are not accessible to independents. The lack of available capital to develop "proven" reserves is due to a number of factors. One is the fact that development operations contain a good deal of risk (22 percent of development wells results in dry holes). Additionally, the vast majority of U.S. development wells are not what one would call prolific. The cost of drilling and producing U.S. "proven" reserves is high relative to barrels of oil produced. Consequently, in periods of low and volatile prices the much needed capital to maintain U.S. production levels is not forthcoming.

- We recommend that expenditures qualifying for the credit include all expenditures to find and develop oil and natural gas reserves, including geological and geophysical expenditures as well as all costs of drilling and equipping oil and natural gas wells.

- We recommend that the credit percentage be increased to 20 percent.

- The President proposes that the credit be partially applicable against the alternative minimum tax. We propose that it be 100 percent applicable against the minimum tax. However, no carryback period of the credit is provided for in the President's proposal. A long carryback period of the credit should be provided in order to benefit independent producers, many of whom have had little taxable income, if any, in the past few years. Further, many cannot currently project any significant increase in taxable income in the immediate future.

- The President also proposes that all credits be phased out when the price of oil reaches $21 a barrel. While we understand the need for a phase-out mechanism, we believe that a phase-out tied to the level of imports is both more logical and better policy. Crude oil price volatility would degregate the value of a tax credit if the phase-out is based on a given removal value for crude oil because investment decisions would be made without any assurance that the credit would be available. For example, a capital outlay made in January when crude oil prices averaged $15 a barrel would not necessarily be eligible for the credit if subsequent price hikes occurred during the year. This would hold true even if a subsequent price collapse occurred. Tying the credit to import levels insures that the primary objective of the legislation, enhancing domestic production to offset imports, is achieved.

Alternative Minimum Tax Relief

On the President's proposal to exclude 80 percent of preference intangible drilling costs (IDC) on exploratory wells from the alternative minimum tax calculation, we offer the following comments:

- We agree with the President that minimum tax relief for the independent is essential to getting our drilling rigs back to work. The IDC preference penalizes independents who risk capital to search for oil and natural gas reserves. At some point the independent stops his drilling activities due to the IDC preference. We recommend that the intangible drilling costs be deleted altogether as a preference item. Failure to do so results in each exploration dollar generating $.21 in taxes just for the privilege of spending that dollar. Taxpayers should not be penalized on the expenditure of risk dollars.

- In the spirit of the Tax Reform Act of 1986, we would be favorably disposed to limit the President's proposed AMT modifications to independents who materially participate in the business of drilling and production (as long as a line of business approach is adopted).

Repeal of Transfer Rule

The President proposed two modifications to statutory depletion accorded independent producers. One of the proposals is to repeal the transfer rule which would encourage the more cost efficient independent to purchase marginal properties from integrated companies and thus prolong the life of marginal U.S. reserves. On this proposal we offer the following comments:

- The transfer rule prohibits independents from claiming statutory depletion on properties that were "proven" before the independent acquired ownership of the property. The rule was enacted to prevent integrated oil companies from indirectly benefiting from tax provisions accorded only to independents by selling producing properties to independents at inflated prices. This perceived potential abuse is unwarranted. Any property transfer between integrated oil companies and independents would involve a sales price. This sales price establishes a cost basis for the property in the hands of the independent. This basis is eligible for cost depletion which in our experience is usually higher than statutory depletion. Consequently, there is no substantial economic benefit to extending statutory depletion to transferred properties. The only time that a substantial benefit would occur would be when a significant price spike occurs relative to the price of oil at the time of purchase. However, the repeal of the transfer rule may offer some psychological encouragement for independents to purchase marginal properties from integrated companies (i.e. betting on the come), and for this reason we support its repeal.

- In any event, repeal of the transfer rule would add to Treasury revenues as opposed to being a revenue loser. That is, the additional cost depletion deductions would be spread out over a number of years while the gain on the sale would be taxable immediately. Further, an income generating asset is maintained.

Additional Suggestions on Depletion

Repeal of the transfer rule alone would not provide the incentive necessary to keep our marginal properties producing without additional depletion modifications. Changes in the depletion rules for marginal production that would significantly encourage the more cost efficient independent to purchase and maintain marginal U.S. reserves and thus enhance U.S. energy security would include:

- Increasing statutory depletion for marginal properties, and eliminating statutory depletion on production from marginal properties as a preference item.

- Removing marginal production from the 1,000 b/d limitation. Depletion can only be claimed on 1,000 barrels of oil (or the natural gas equivalent) production per day. The removal of this restriction could allow the larger and more financially able independent to benefit from the additional statutory depletion deductions from purchased marginal properties.

- Eliminate the property net income limitation. Any increase in the statutory depletion rate is of virtually no benefit unless the property net income limitation is repealed or raised due to the marginal net incomes of properties involved.

- Repeal the 65 percent taxpayer income limitation with respect to statutory depletion claimed on marginal production.

Increase Net Income Limitations

We believe that these depletion modifications, taken as a whole, would significantly encourage independents to acquire and maintain marginal production. The President has already proposed raising the net income limitation from 50 percent to 100 percent. Due to other statutory depletion limitations and the fact that excess statutory depletion is a preference item, any increase in statutory depletion without minimum tax relief is of absolutely no benefit and may even be a detriment to the independent. The vast majority of independents currently cannot sustain all of the "allowable" statutory depletion and in fact have large unusable depletion carryforwards.

Again, we applaud the President's recommendations as a long overdue step in the right direction in establishing a national energy policy--a policy which recognizes the national need for a viable domestic energy industry.

We believe that the adoption of our recommended changes to the President's tax proposals would have a significantly greater impact on the domestic oil and natural gas industry and to the nation's economic well being in terms of energy security.

IPAA endorsed Legislation

We have endorsed the "Energy Security Incentive Act-HR 658" and the "Domestic Energy Security Act-HR 664." The bills are very similar in nature, and, as mentioned earlier, follow the outline of the President's proposals. The main thrust of the legislation encourages new exploration and maintenance of economically marginal production. The bills provide a tax credit for new exploration and development of oil and natural gas and maintenance of economically marginal oil and gas wells. The credit would apply against both the regular and alternative minimum tax.

In addition, the bills provide relief from the alternative minimum tax. The bills also include a number of other exploration and production incentives such as expensing of geological, geophysical and unrecoverable surface casing costs; repeal of the transfer rule; repeal of net income limitations; and reinstatement of tight sands under provisions of the Section 29 tax credit.

The legislation is a healthy start for an industry ready to get back on its feet.

Conclusion

In conclusion, I would like to emphasize that tax incentives to revitalize the domestic oil and natural gas industry are needed now. The independent oil and natural gas industry is rapidly disappearing. Many independents and service companies have gone out of business; others are simply being depleted out of the business because sources of capital to replace produced reserves are unavailable. Our ability to drill for new reserves is shrinking as drilling rigs are cannibalized and scrapped, and as manufacturing capacity diminishes.

But there is more to an industry than plant capacity. Every industry needs capable and trained personnel. In 1983, the entire U.S. undergraduate petroleum engineering student body was 10,500. Today it stands at less than 1,900. Of this number, less than 300 are freshmen. The domestic oil and natural gas industry is experiencing an exodus of not only independent operators and supporting oilfield industries, but also trained geophysists, geologists, engineers and oilfield workers. During last year's drought, a Congressman in arguing for farm relief said "we will need our farmers in the future, we cannot allow them to disappear."

It is important to note that any one of the items proposed, if enacted alone, would do very little to help. The entire package of proposals is needed, and even taken all together will not solve our domestic petroleum supply problems. But it at least would be a positive beginning.

Mr. Chairman, we need a viable independent oil and gas industry to be able to respond to rising levels of imports. We cannot wait to provide incentives to develop and maintain U.S. reserves until a crisis occurs - for there may not be a strong independent industry segment to respond - it will have disappeared.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

STATEMENT OF
GEORGE SINGER
Representing the
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
AND

AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
ASSOCIATION OF OILWELL SERVICING CONTRACTORS
CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
COASTAL OIL AND GAS ASSOCIATION
EASTERN KANSAS OIL AND GAS ASSOCIATION, INC.
EAST TEXAS PRODUCERS AND ROYALTY OWNERS ASSOCIATION
ENERGY CONSUMERS AND PRODUCERS ASSOCIATION
GEORGIA OIL AND GAS ASSOCIATION
ILLINOIS OIL AND GAS ASSOCIATION
INDEPENDENT OIL AND GAS ASSOCIATION OF NEW YORK
INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA
INDEPENDENT OIL PRODUCERS' AGENCY
INDEPENDENT OIL PRODUCERS ASSOCIATION TRI-STATE, INC.
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO
INDIANA OIL AND GAS ASSOCIATION
INTERNATIONAL ASSOCIATION OF DESK AND DERRICK CLUBS
INTERNATIONAL ASSOCIATION OF GEOPHYSICAL CONTRACTORS
KANSAS INDEPENDENT OIL AND GAS ASSOCIATION
KENTUCKY OIL AND GAS ASSOCIATION
LIAISON COMMITTEE OF COOPERATING OIL AND GAS ASSOCIATIONS
LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS
LOUISIANA LANDOWNERS ASSOCIATIONS, INC.
MICHIGAN OIL AND GAS ASSOCIATION
NATIONAL STRIPPER WELL ASSOCIATION
NEW MEXICO OIL AND GAS ASSOCIATION
NEW YORK STATE OIL PRODUCERS ASSOCIATION
NORTH TEXAS OIL AND GAS ASSOCIATION
OHIO OIL AND GAS ASSOCIATION
OHIO PETROLEUM PRODUCERS ASSOCIATION
OIL INVESTMENT INSTITUTE
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
ORANGE COUNTY PETROLEUM ASSOCIATION
PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION
PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION
PENNSYLVANIA NATURAL GAS ASSOCIATES
PENNSYLVANIA OIL AND GAS ASSOCIATION
PERMIAN BASIN PETROLEUM ASSOCIATION
ROCKY MOUNTAIN OIL AND GAS ASSOCIATION
ROYALTY OWNERS AND INDEPENDENT OIL AND GAS PRODUCERS ASSOCIATION OF ARKANSAS
TENNESSEE OIL AND GAS ASSOCIATION
VIRGINIA OIL AND GAS ASSOCIATION
WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

Before the House Committee on Ways and Means
Hearing on Revenue Proposals
Contained in the President's Budget for Fiscal Year 1990
April 12, 1989

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Mr. ANDREWS. Thank you, Mr. Singer. Mr. Woods.

STATEMENT OF JAMES D. WOODS, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BAKER HUGHES INC., HOUSTON, TX, AND PRESIDENT, PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

Mr. WOODS. Thank you, Mr. Chairman. My name is James D. Woods. I am chairman, president, and CEO of Baker Hughes, Inc., located in Houston, TX. I am also the incoming president of the Petroleum Equipment Suppliers Association.

Today I also speak for the Association of Oil Well Servicing Contractors, the International Association of Drilling Contractors, the International Association of Geophysical Contractors, the National Ocean Industries Association, and the Offshore Marine Services Association.

These associations represent over 2,200 firms with over 250,000 employees in the United States. These firms represent the majority of the companies that make up the infrastructure of the petroleum industry and manufacture the equipment, and provide the manpower and supplies rendered to explore and develop our Nation's oil and gas resources.

The major and independent oil companies purchase these products and services from the member companies to conduct their exploration and production program.

In 1988, we estimate the U.S. market for these products and services to be around $13 billion. On behalf of the coalition, I wish to express my strong support for the domestic drilling incentives proposed by Congressman Archer and Congressman Andrews, presently cosponsored by 75 Members of Congress.

These bills would give a badly needed shot in the arm to an industry that has been in a severe depression since 1982. In my prepared statement you will find graphs highlighting the decline in the U.S. drilling activity.

Low oil prices, and the perception that prices would not improve led to a fall in the number of active rotary rigs from an annual average of 3,970 in 1981 to 963 in 1986.

That number has remained below 1,000 rigs for 3 consecutive years, and unless some kind of incentive is added, we do not expect it to improve significantly in the next 2 years.

As a point of reference, the U.S. rotary rig count averaged less than 1,000 only 1 year between 1944 and 1985. It has been below 1,000 for the last 3 years. In fact between 1944 and 1985, there were only 14 months in which the rig count averaged below 1,000.

In the last 3 years it has been below a 1,000 30 months. Today's count is 778 rigs. Imports of crude and petroleum products have grown by 2 million barrels a day, and they now comprise 42 percent of U.S. oil demand compared to 33 percent in 1982.

The growth in imports has aggravated our foreign trade deficit, last year estimated to be around $39 billion of the deficit, or roughly a third.

The cost of oil imports is anticipated to double by 1995 by recent studies done at Southern Methodist University. The infrastructure of the industry—U.S. service companies, manufacturers, contractors—we have been shattered during the period 1981 to 1986.

The Bureau of Labor Statistics reported 619,000 employees in the U.S. oil and gas service sector in March 1982. That number has fallen to 253,000 in January 1989. But the numbers tell only part of the story.

A substantial portion of the work force consists of highly trained professionals, and it is unlikely that most of them will return to this industry. It would take time to replace this expertise that has been lost.

Estimates show that it takes us about 3 years to get a new graduate engineer to operate at 90-percent efficiency in the field. To ensure maximum utilization of our domestic resources we must have significantly greater drilling activity than we have had in recent years.

It should be remembered that in the early 1980's, over 4,000 rigs were required to maintain U.S. oil production—that was just to maintain our level—and during the period where we had 4,000 rigs working, we only increased natural gas availability by 10 percent.

To find and develop reserves operators need incentives. Unfortunately, not only have our crude prices fallen in the past few years, but they have been extremely volatile. Crude prices for West Texas intermediate crude oil are at the highest levels in almost 2 years, but less than 4 months ago they were at a 2-year low.

This recent history of volatility has made operators question the stability of prices, thus complicating investment decisions. As a result, U.S. drilling activity as measured by the U.S. rig count, will fall to the lowest annual average since 1942. Those are this year's numbers.

We are now approaching a 1930 U.S. drilling activity level when the GNP in this country was approximately one-eighth of what it is today.

The incentives proposed in the Archer-Andrews bills would provide a tangible benefit to operators and drive additional drilling activity when crude prices alone are not sufficient.

I will just wrap it up by saying that the industry that we service, or the industry that I represent here today, the various associations—keep this in mind—that we have contracted from a U.S. activity base of 4,530 rigs in December 1981 to a low of 663 in July 1986. That is a total market erosion, if you are in my business, of 85 percent.

Once again, today's rig count is 778 rigs, and from our high point in 1981, that is a decline of over 80 percent. Thus, the ability for the service companies to service the drilling activity necessary for our security has deteriorated significantly, and will continue to do so, unless domestic operators have adequate incentives to focus on what they do best—find and produce oil and gas.

Our industry's problems today threaten America's energy security tomorrow. Thank you, Mr. Chairman.

[The statement of Mr. Woods follows:]

Statement of James D. Woods -4-12-89

Mr. Chairman, Members of the Committee, my name is James D. Woods. I am Chairman, President and Chief Executive Officer of Baker Hughes Incorporated located in Houston, Texas. I am also the incoming President of the Petroleum Equipment Suppliers Association.

Today I also speak for the Association of Oilwell Servicing Contractors, International Association of Drilling Contractors, International Association of Geophysical Contractors, National Ocean Industries Association and the Offshore Marine Services Association. These associations represent over 2,200 firms which employ over 250,000 people.

These firms represent the majority of the companies that make up the infrastructure of the petroleum industry and manufacture the equipment and provide the manpower and supplies required to explore and develop our nation's oil and gas resources. The major and independent oil companies purchase these products and services from the member companies to conduct their exploration and production programs. In 1988, the U.S. market for these products and services was approximately $13 billion.

On behalf of the coalition, I wish to express my strong support for the domestic drilling incentives proposed by Congressman Bill Archer in HR-664 and Congressman Mike Andrews in HR-658. Presently co-sponsored by 75 members of Congress, these bills would give a badly needed shot in the arm to an industry that has been in a severe depression since 1982.

Low oil prices and the perception that prices would not improve led to a fall in the number of active rotary rigs from an annual average of 3970 in 1981 to 963 in 1986. That number has remained below 1,000 for three consecutive years and we do not expect it to improve significantly in the next two years. The number of seismic crews working, the means by which operators locate new exploration prospects, declined from an annual average of 681 in 1981 to 185 in 1988. So far, 1989 has averaged 138. The number of workover rigs, which perform maintenance and stimulation procedures to maintain production from existing wells, has fallen from an annual average of 4,850 in 1981 to 3,341 in 1988. Again, 1989's year to date average of 3,112 indicated a continuing decline.

Reduced drilling activity has led to fewer well completions. In 1981, the American Petroleum Institute reported the completion of 42,520 oil wells and 19,742 gas wells. Those numbers fell to an estimated 15,500 oil wells and 7,700 gas wells in 1988 representing declines of 64% and 61% respectively. The Department of Energy has reported a decline in oil reserves for four of the last six years and a decline in gas reserves for each of the last six. U.S. crude production has fallen by 520,000 bbl/day since 1982, despite a 321,000 bbl/day increase from Alaska. Imports of crude and petroleum products have grown by 2 million bbl/day and now comprise 42% of U.S. oil demand compared to 33% in 1982.

The growth in imports has aggravated our foreign trade deficit. Last year oil imports ran about $39 billion comprising roughly a third of our deficit. The cost of oil imports is expected to double by 1995 according to a recent study done at Southern Methodist University.

The infrastructure of the industry I referred to earlier has been shattered during this time period. The Bureau of Labor Statistics reported 619,000 employees in the oil and gas service sector in March of 1982. That number has fallen to 253,000 in January of 1989, but numbers tell only part of the story. A substantial portion of this work force consists of highly trained professionals. These people have been forced by layoffs to pursue other careers. It is unlikely that most of them will return to the industry. It would take time to replace the expertise that has been lost. Estimates show that it could take three years of training to get a new employee to operate at ninety percent efficiency in the field.

The number of drilling rigs available fell from over 5,600 in 1982 to about 2,500 today. Due to cannibalization and lack of funding for maintenance the actual number of useable rigs is probably closer to 1500. Service companies faced a monumental challenge coping with the market collapse, but a percentage have managed to survive. Overall, the operating capacity of the industry has been drastically reduced.

The demand for oil in the U.S. is forecast to rise by 1% -2% per year over the next several years. Natural gas consumption is also expected to rise as demand increases in response to continuing economic growth and environmental pressures. To satisfy this demand our nation will either find and develop new domestic reserves or face increasing reliance on foreign sources of supply. To ensure maximum utilization of our domestic resources, we must have significantly greater drilling activity than we have seen in recent years. It should be remembered that over 4,000 rigs were required to maintain oil production and increase natural gas deliverability by 10% in the early 80's.

To find and develop reserves, operators obviously need economic incentives. A good price for their product is the best reason to drill. Not only have crude oil prices fallen during the past few years, but they have been extremely volatile. Crude prices for West Texas Intermediate are at the highest levels in almost two years, but less than four months ago they were at a two year low. This recent history has made operators question the stability of prices, thus, complicating investment decisions. As a result, drilling activity, as measured by the rig count, will fall to the lowest annual average since 1942. We are now approaching 1930's U.S. drilling activity levels when the GNP was one-eighth of what it is today. The incentives proposed in the Archer/Andrews bills would provide a tangible benefit to operators and drive additional drilling activity when crude prices alone are not sufficient.

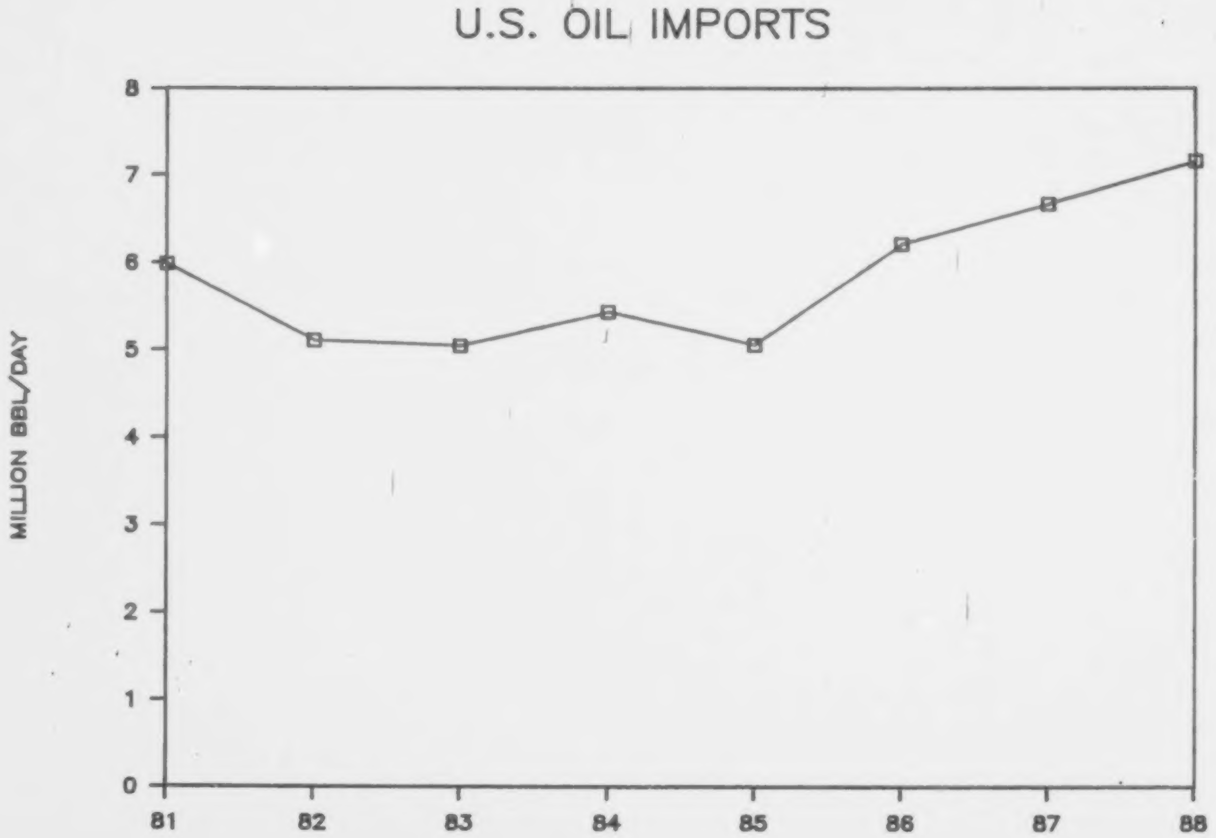
International drilling activity provides an excellent example of how incentives can provide stability. Foreign governments often offer tax incentives that make drilling attractive even in volatile pricing environments. Consequently, the foreign rig count has remained remarkably stable over the past three years. The Canadian rig count shows graphically what happens when incentives are removed. In the past two years, Canadian drilling activity has fallen significantly after every incentive expiration.

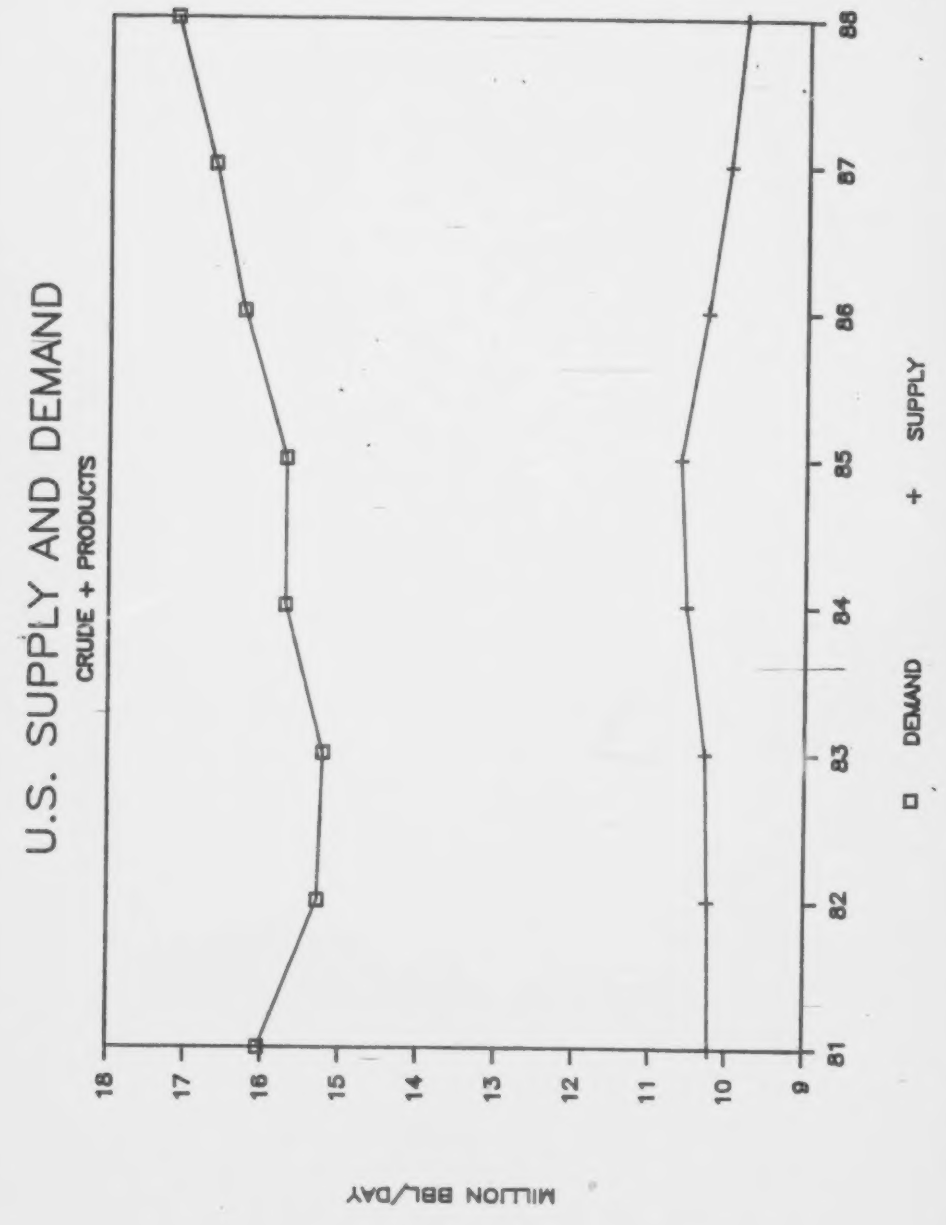
The amount of additional investment resulting from incentives would, of course, depend on the extent of the measures initiated. Our BHI drilling model indicates that the 1989 average rig count would increase by one rig for every ten million dollars invested. Additional rigs would mean additional reserves of oil and gas added to a declining base.

Increasing the additional number of active rigs would provide additional jobs in drilling and support services that would result in additional income tax revenues. The incremental oil and gas reserves that are found would mean additional production which would, of course, also generate tax revenues. This additional production would also reduce the volume of imported oil and gas required, and therefore, have a positive impact on our trade deficit.

We do not believe these incentives will solve all the problems faced by the U.S. service industry today. Price volatility will continue to plague our industry through the early 1990s. This will make operators more hesitant to increase drilling expenditures. We do believe that these incentives will offset crude oil price instability to a certain extent and would be a vital first step in inducing additional activity to alleviate a problem that threatens the economic and strategic security of our nation. Our ability to service the drilling activity necessary for this security has deteriorated significantly and will continue to do so unless domestic operators have adequate incentives to focus on what they do best; find and produce oil and gas. Our industry's problems today threaten America's energy security tomorrow.

Mr. Chairman, Members of the Committee, I thank you for your time and will be happy to answer any questions you may have.


U.S. OIL IMPORTS


U.S. SUPPLY AND DEMAND
CRUDE + PRODUCTS
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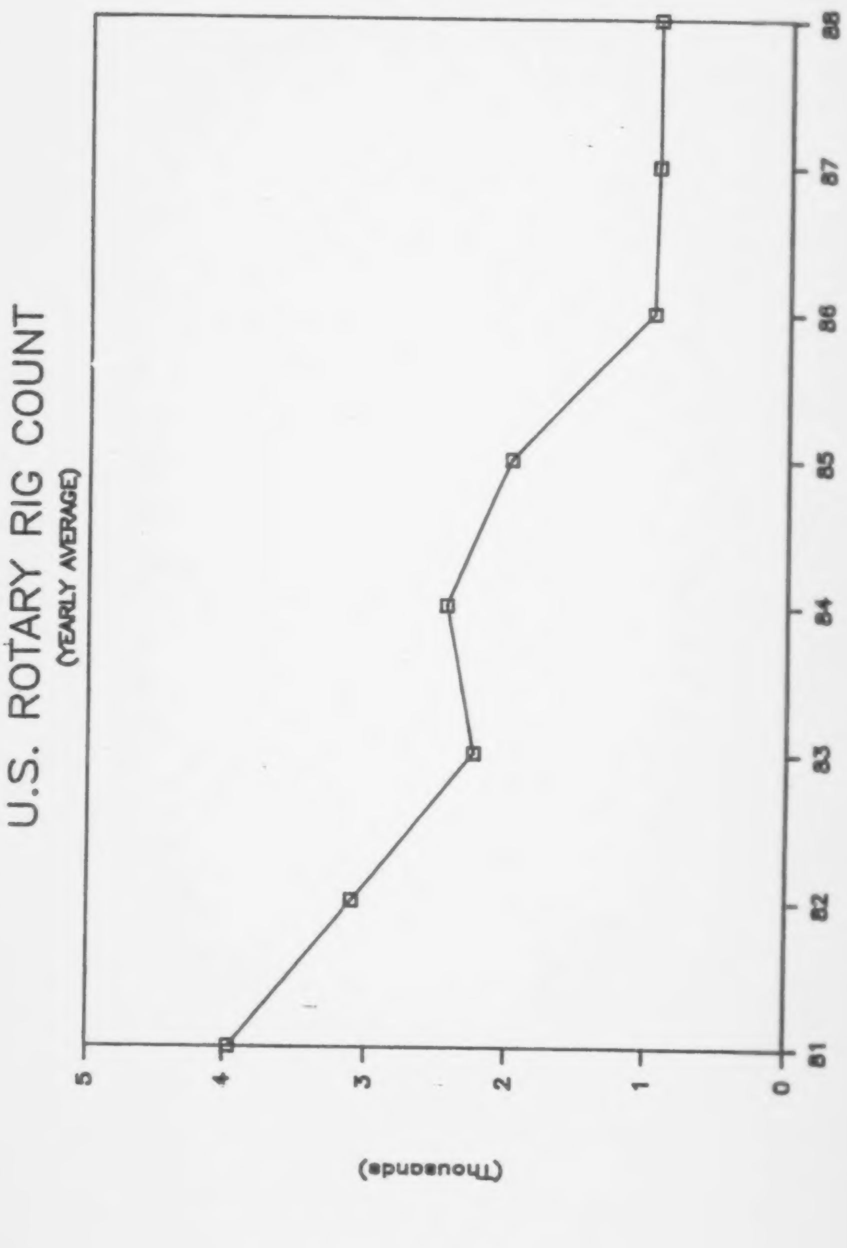
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(YEARLY AVERAGE)
(Thousands)
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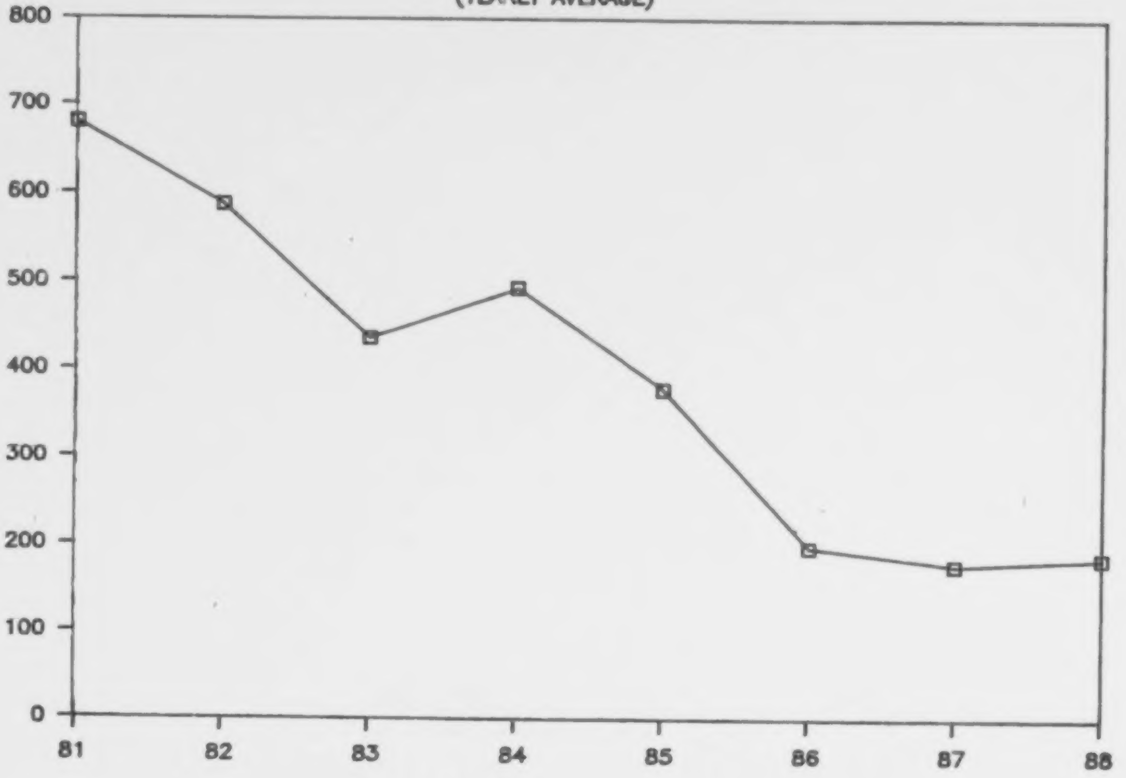
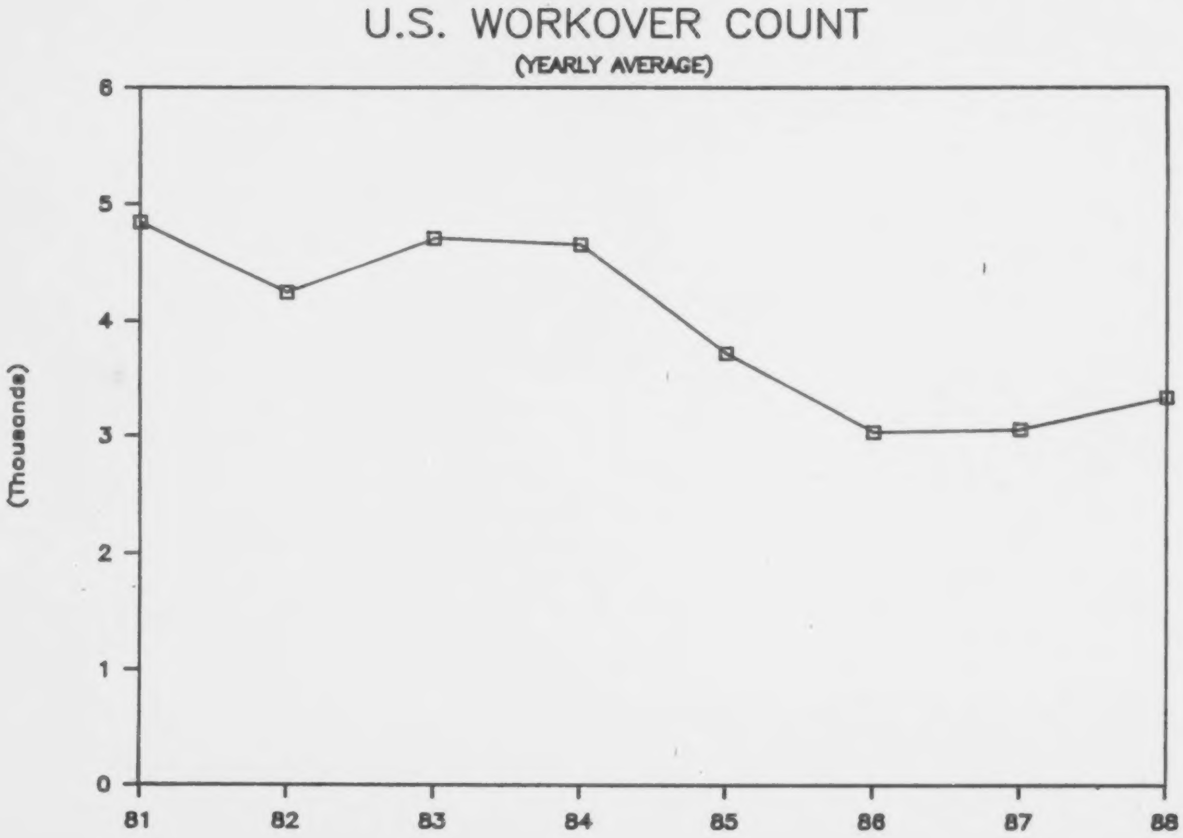
U.S. SEISMIC CREW COUNT
(YEARLY AVERAGE)




U.S. WORKOVER COUNT
(YEARLY AVERAGE)
(Thousands)
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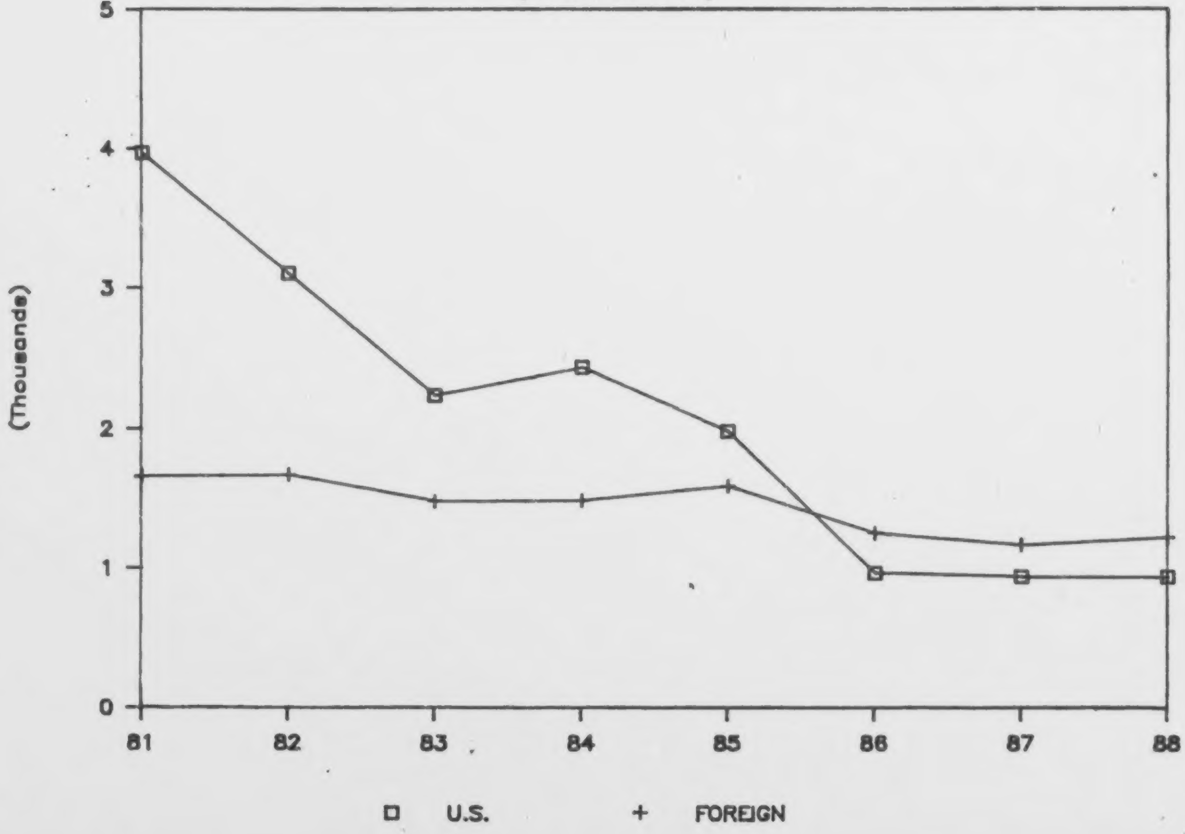
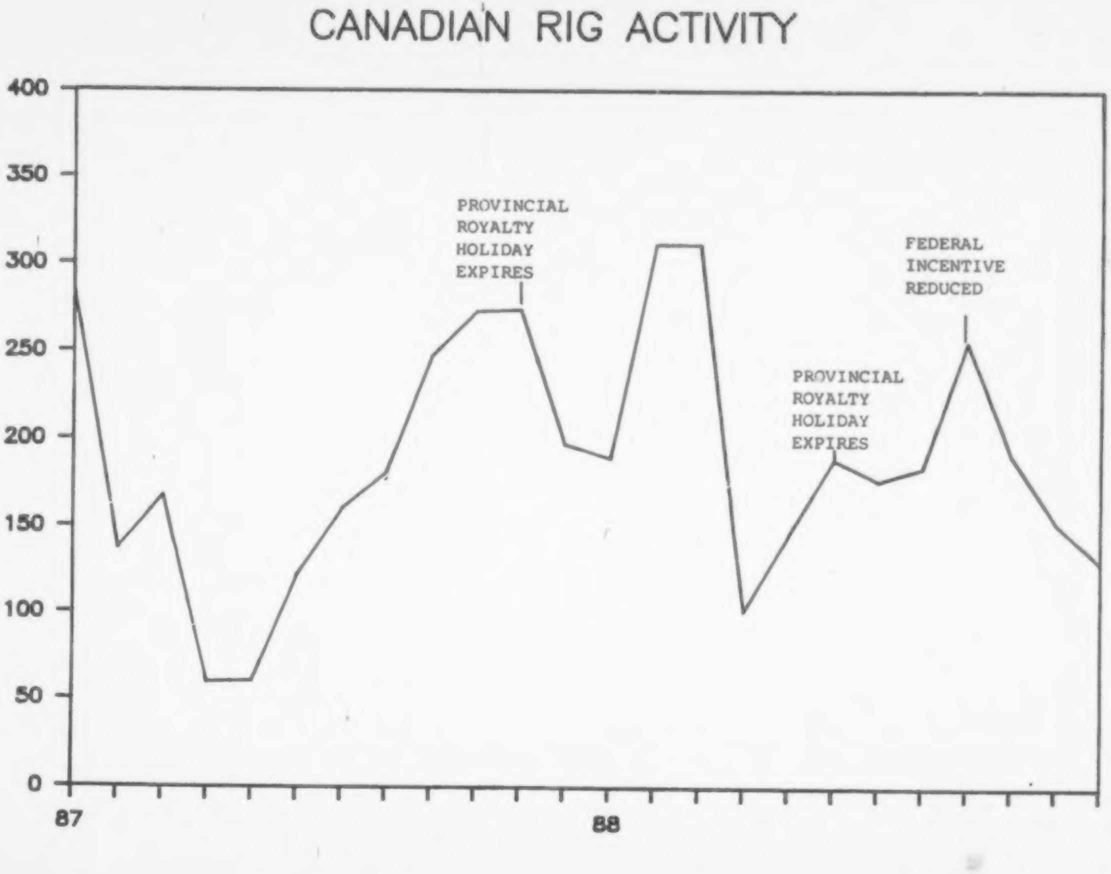
U.S. VS. FOREIGN RIG COUNT
(YEARLY AVERAGE)





CANADIAN RIG ACTIVITY

Mr. Andrews. Thank you. Mr. DiBona.

STATEMENT OF CHARLES J. DiBONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE

Mr. DiBona. My name is Charles DiBona, president of the American Petroleum Institute. I appreciate the opportunity to testify before you today.

In recent years, energy policy has not received the attention it deserves. Meanwhile, the Nation's energy security has deteriorated. Yet there is a great deal the Federal Government can do to reduce U.S. dependence on oil imports and improve our energy security and economic well-being.

Increased leasing of Federal lands and decontrol of natural gas wellhead prices, for example, would be quite helpful. Energy tax incentives, too, play an important role.

We, in the petroleum industry, applaud the President's leadership in proposing such incentives, and we are pleased that the Congress is considering them, and that, in particular, Mr. Archer and Mr. Andrews have looked at ways to improve on that.

Before turning to tax incentive proposals, I would like to review some recent energy trends that indicate the severity of the Nation's energy problem.

During the past 3 years U.S. oil production has trended downward while domestic consumption has increased substantially. These trends reflect the fall in world oil prices which began in the early 1980's and accelerated sharply in 1986.

Consequently, U.S. gross oil imports rose from 4.9 million barrels per day, or 31 percent of consumption, in 1985, to 7.2 million barrels per day, or 42 percent of consumption, in 1988.

About four-fifths of this increase in imports came from OPEC producers, with the bulk of that from the Middle East. The trends towards greater domestic oil consumption and lower production continued in early 1989. As a result, oil imports recently accounted for 45 percent of domestic consumption.

The imports' share now is approaching a peak of 48 percent reached in 1977. Leading indicators of U.S. petroleum production, including capital expenditures for exploration and production, drilling rig activity and well completions, point to a continued decline in domestic production.

Reserves of oil and natural gas have been decreasing as a result of the falloff in exploration and development. Moreover, forecasts of longer term prospects also are pessimistic.

For example, the U.S. Department of Energy's base case projection in its 1989 annual energy outlook looks for U.S. gross oil imports to reach 57 percent of consumption in 1995, and 59 percent of consumption in the year 2000.

Although the Department projects some growth in oil consumption, it expects most of the import increase to be due to a fall in domestic production. Larger domestic petroleum production will reduce demand for oil imports, but downward pressure—put downward pressure on world oil prices, decrease U.S. vulnerability to a supply shortfall anywhere in the world, improve the U.S. trade balance, and improve the Nation's utilization of its resources by employing now idle capital equipment and labor.

Given these facts, it is important that prudent public policies are pursued in the energy field. Unwise decisions will aggravate a serious situation. The administration's energy tax incentive proposals which call for tax credits for exploratory and tangible drilling costs, and for expenditures on new tertiary-enhanced recovery projects are an important step in the right direction.

The proposals, however, are limited in scope, and they do not provide equal incentives for all petroleum companies. These factors limit the program's potential benefits for the Nation.

A more comprehensive approach like that contained in H.R. 664, sponsored by Congressmen Archer and Andrews, and others, would expand the President's initiative and provide stronger incentives for domestic petroleum development.

The major provisions of this bill—a tax credit for all exploratory and development drilling, and a production credit for high-cost oil such as stripper oil from enhanced recovery projects and offshore oil produced in deep water areas—would have a significant positive impact on domestic petroleum production that would slow its decline.

Thus, H.R. 664's incentives would provide important economic and energy security benefits. Thank you, Mr. Chairman.

[The statement of Mr. DiBona follows:]

STATEMENT OF CHARLES J. DIBONA, PRESIDENT
AMERICAN PETROLEUM INSTITUTE

Introduction

The following discussion first will examine trends in U.S. petroleum markets and then focus upon energy tax issues.

Recent Trends in U.S. Petroleum Consumption, Production and Imports

During the past three years, there have been dramatic reversals from previous U.S. oil demand and supply trends. From the late 1970s through the mid-1980s, U.S. oil consumption fell substantially while domestic production rose modestly. Consequently, U.S. gross oil imports fell from a peak of 8.8 million barrels per day (MMBD) or 48 percent of consumption in 1977 to 4.9 MMBD or 31 percent of consumption in 1985. These trends, however, were reversed after 1985, reflecting the fall in world oil prices that began in the early 1980s and accelerated sharply in 1986. Between 1985 and 1988, annual U.S. oil consumption rose by 1.4 MMBD while annual domestic production (including natural gas liquids) fell by 0.8 MMBD. As a result, U.S. gross oil imports rose from 4.9 MMBD in 1985 to 7.2 MMBD or 42 percent of consumption in 1988.

The trends toward greater domestic oil consumption and smaller production continued in early 1989. In the first two months of this year, U.S. oil consumption was about 400,000 barrels per day higher than in the comparable period of 1988, while oil production including natural gas liquids was down by about 300,000 barrels per day. Moreover, Alaskan production recently has fallen below year-earlier levels, which may well be the start of a reversal of the upward trend in Alaskan production that had lasted for several years.

So far this year, U.S. oil imports have exceeded the level of domestic crude oil production. Natural gas liquids output and other smaller domestic supply components keep the supply balance tipped toward the domestic side. Nevertheless, February's gross oil imports accounted for 45 percent of domestic consumption, not only higher than the 42 percent average for full year 1988 but also far above the 31 percent level recorded in 1985. The vast majority of the increase in imports during the past three years or so has come from OPEC producers with the bulk of that from the Middle East, reflecting the geographic distribution of worldwide incremental production capacity.

Likely Future Trends in U.S. Oil Markets

The important question is whether these trends are likely to continue, making the U.S. more and more dependent on imported oil, or whether they can be influenced by public policy decisions. Developments in oil markets over the past few years provide considerable information as to what is likely to happen under existing policy. Following is a brief review of this information.

An important leading indicator of future U.S. oil production is domestic capital expenditures for exploration and production. The American Petroleum Institute regularly compiles data on such expenditures by a group of leading oil companies. These companies' expenditures for domestic exploration and production peaked in 1981 at $26.3 billion. They fell by 25 percent to $19.8 billion by 1985, as world oil prices and oil company profitability declined. Although this decline in investment was severe, it was much milder than the falloff that was to follow when world oil prices plummeted after 1985. By 1987, capital expenditures for domestic exploration and production had fallen to $9.6 billion, only about half their 1985 level and one-third of their 1981 level. Although upstream investment increased in 1988 over the depressed 1987 level, such investment still was far below the levels of a few years ago. Moreover, advance indications of company spending plans suggest that investment in domestic exploration and production may decline again in 1989.

Since drilling and related costs have fallen substantially in recent years, trends in capital spending for exploration and production may not tell the full story of what is actually occurring. Drilling rig activity and well completions, however, corroborate the story told by the capital expenditure data. The number of drilling rigs operating in the U.S. recently has been in the 700-800 range, compared to 1,980 in 1985 and 3,970 in the peak year of 1981.

Consequently, the number of oil and natural gas wells completed in the U.S. has plummeted. Less than half as many wells were completed in 1988 as in 1985 and only about one-third as many as in 1981. Oil well completions have fallen by about 60 percent in the last three years, while natural gas well completions have declined by about 48 percent.

Oil reserve additions have been suffering as a result of the price fall and decline in oilfield activity. Gross reserve additions in the lower 48 states have fallen from 2.9 billion barrels per year for the two years before the 1986 price collapse to 1.0 billion barrels in 1986 and 2.0 billion barrels in 1987. Thus, despite the drop in oil production and the booking of additional reserves in Alaska as projects there were completed, total U.S. crude oil reserves fell from 28.4 billion barrels at the end of 1985 to 27.3 billion barrels at year end 1987 (the latest data available).

Furthermore, the U.S. no longer has the vast natural gas excess deliverability capability that it had in the mid-1980s. U.S. consumption of natural gas increased in 1987 and 1988, after declining by about 26 percent between 1973 and 1986. The U.S. Department of Energy now expects U.S. demand for natural gas to grow by about 14 percent through the year 2000. Yet, natural gas development has slowed substantially in the U.S.: gas well completions fell from a peak of about 20,000 in 1981 to only about 7,300 last year, and U.S. natural gas reserves declined every year during the 1981-1987 period. Indeed, the Department of Energy expects U.S. natural gas production to grow more slowly than demand during the next decade or so, causing U.S. imports of natural gas as well as oil to rise.

All this obviously does not augur well for future U.S. oil production. Projections by private organizations as well as government authorities look for a continued production decline over the longer term as well as the near term, with the speed of the decline dependent upon the future course of oil prices.

For example, in 1986 the American Petroleum Institute conducted a survey of American oil companies to estimate the effects of the fall in oil prices. Companies were asked to estimate their domestic oil production through 1991 under various oil price scenarios, and the results were aggregated and scaled up to give an industry-wide picture. The survey results correctly anticipated that the 1986 price drop would have a marked negative impact on industry production. Even at an assumed price of $20 per barrel through 1991 in real 1985 dollars -- a price well above the average price since the 1986 survey was taken -- the industry's crude oil production was expected to decline from 8.9 million barrels per day in 1985 to 7.5 million barrels per day in 1991, or by an annual average of about 200,000 barrels per day. At a $15 price, production was expected to fall each year by an average of about 450,000 barrels per day; while at $10, production was expected to fall each year by an average 800,000 barrels per day. Since early 1986, the annual production decline has averaged about 400,000 barrels per day, which is on track with the 1986 survey projections.

The U.S. Department of Energy's projection recently published in its 1989 Annual Energy Outlook also is quite pessimistic. The

Department's "base case" looks for U.S. oil production including natural gas liquids production to fall from 9.9 million barrels per day in 1988 to 8.0 million barrels per day in 1995 and to 7.8 million barrels per day in the year 2000, assuming that the world oil price rises in real terms at an average rate of 5.5 percent annually. The Department's alternative "low price" case, which assumes that the oil price will rise in real terms at an average of 3.3 percent annually, looks for production to fall to 7.7 million barrels per day in 1995 and to 7.1 million barrels per day in 2000. Even though the Department of Energy projects relatively slow growth in U.S. oil consumption -- 0.8 percent per year in the base case and 1.2 percent per year in the low price case -- it nevertheless expects oil imports to increase substantially. In the base case, gross oil imports are projected to equal 57 percent of 1995 consumption and 59 percent of consumption in 2000. In the low price case, imports are projected at 60 percent of 1995 consumption and 65 percent of consumption in 2000.

Increased U.S. demand for imported oil will strengthen the OPEC cartel and make it more likely that oil prices will rise in the future. The United States is a large net importer of oil, and thus the nation's real income is reduced when oil prices rise. Greater import dependency will also increase the risk of damage to the U.S. economy should there be a significant cutoff of oil supplies anywhere in the world. In addition, growth in oil imports worsens the U.S. trade balance.

All this makes it essential that wise public policies are followed. There is a great deal that the federal government can do to slow the rise in imports and thereby improve our nation'~~s~~ and indeed the free world's energy security and economic well-being. The failure to take the steps that can and should be taken will result in becoming even more dependent on imports than we need to be. Prompt government action, on the other hand, could substantially increase the amount of domestic oil and natural gas found and developed by the early 1990s and produced from then until well beyond the year 2000. To do so, government should act now to encourage greater energy exploration and development. Increased leasing of federal lands, decontrol of natural gas wellhead prices, and the avoidance of unnecessarily costly regulatory requirements all would be helpful. In addition, changes in federal tax policies can make an important contribution toward providing a more secure energy future.

Energy Tax Proposals

The Administration's energy tax proposals -- which call for a 10 percent tax credit for the first $10 million of a company's annual expenditures on exploratory intangible drilling costs and a five percent credit for the balance of such expenditures, a 10 percent tax credit for capital expenditures on new tertiary enhanced recovery projects, elimination of the "transfer rule," an increase in the net income allowance to 100 percent for percentage depletion by independent producers, and elimination of 80 percent of intangible drilling cost tax preferences from minimum tax for independent producers -- would provide some incentives for exploration and increased recovery from existing fields. They are a step in the right direction, and we are pleased that the President has shown leadership in this vital area.

The Administration proposals, however, are limited in scope, and they do not provide equal treatment for all petroleum companies. These factors restrict the program's potential benefits to the nation.

The benefits of a tax incentive program will be reduced if the government restricts eligibility based upon company size or degree of integration. Both the large integrated petroleum companies or "majors" and the non-majors or "independents" play important roles in finding and developing oil and natural gas in the United States, and thus both should receive the same incentives. A January 1989 study by the Petroleum Industry Research Foundation, Inc. (PIRINC), The Role of the Majors in Oil and Gas Exploration and Production, found that 16 major oil companies accounted for over half of domestic oil and natural gas production in 1987. At year end 1987, these companies held over two-thirds of domestic proved oil reserves and almost half of proved natural gas reserves. Although the majors typically drill a relatively small portion of all the wells drilled in the U.S. -- 17 percent in 1987 -- they focus on high-risk and potentially high-reward prospects, and they typically find much more oil and natural gas per well than do the independents. PIRINC found that during the 1980-1987 period the majors booked an average of 345,000 barrels of oil equivalent per well drilled (excluding downward revisions in Alaskan North Slope natural gas reserves), compared with 54,000 barrels per well for the rest of the industry.

The American Petroleum Institute favors a more comprehensive approach than the Administration's proposal such as that contained in H.R.664, sponsored by Congressman Archer and Congressman Andrews, and co-sponsored by Congressmen Thomas, Pickle, Combest, DeLay, Stenholm, Barton and Smith.

H.R.664 would provide much broader incentives than would the Administration proposal. For example, under H.R.664 companies would be elegible to receive tax credits for all drilling costs, while under the Administration proposal only a fraction of such costs would qualify. In addition, H.R.664 would provide a credit for the costs incurred to produce stripper oil, heavy oil, oil from enhanced recovery projects, and "harsh environment" oil such as that produced from offshore areas under at least 400 feet of water. Moreover, H.R.664's tax credits would be permanent, unlike the Administration's proposed credits which would be phased out when the price of oil rises to at least $21 per barrel.

In view of the disturbing energy trends discussed above, we believe that a tax incentive program like that embodied in H.R.664 is appropriate. Such a program would have a significant positive impact on domestic petroleum production, slowing the decline in such production. And, an increase in domestic petroleum production above the levels it otherwise might fall to would have important economic benefits -- as well as national security benefits -- for the U.S. and for other oil importing nations as well.

First, greater U.S. petroleum production will reduce the future demand for oil on world markets. Historically, the world oil price has been responsive to changes in demand. Less demand from the U.S., the world's largest oil importer, can exert significant downward pressure on world prices. Thus, greater U.S. production in response to tax changes is likely to reduce the price of future oil imports.

Second, reduced U.S. reliance on oil imports creates greater slack in world oil markets. When there is unused oil producing capacity around the world, there is less opportunity for a single nation or small group of nations intentionally to disrupt world oil supplies and thereby raise the world oil price. Thus, by increasing domestic oil production, the U.S. not only can hold down the world oil price in normal periods but also reduce the chances that a physical disruption of supply would sharply raise the price. Furthermore, the damage to the U.S. economy from a foreign oil supply disruption probably would be reduced if the U.S. is less import dependent.

Third, to the extent that increased domestic petroleum production requires the use of specialized labor and equipment that otherwise would be unemployed, increased U.S. petroleum production will raise employment of labor and capital. Moreover, tax incentives will help keep the industry's infrastructure (i.e., specialized manpower and facilities) in place, so that the industry can expand with fewer bottlenecks in the future.

Fourth, lower U.S. expenditures for oil imports will improve the nation's international trade balance.

Finally, to the extent that energy tax incentives cause greater employment and higher national income, the federal tax base and tax revenues will rise. Under these conditions, there will be at least a partial offset to any loss of federal revenues associated with the provision of energy tax incentives.

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Mr. **Andrews**. Thank you, Mr. DiBona. Mr. Hall.

STATEMENT OF JAMES C. HALL, PRESIDENT, DRILLING & PRODUCTION CO., TORRANCE, CA, AND PRESIDENT, CALIFORNIA INDEPENDENT PETROLEUM ASSOCIATION

Mr. **Hall**. Good morning. My name is Chris Hall and I am the president of the California Independent Petroleum Association, and I sincerely appreciate the opportunity to be able to represent CIPA here today, and for me personally, as it is for many of our members, it is a matter of survival.

CIPA represents approximately 700 members, many of them producers, ranging from single well owners to larger companies. We also represent royalty owners and service companies. Our members are largely onshore producers in the continental United States only.

I should also add that I am president of Drilling and Production Co., a small privately held third generation operating company in the central valley region of California.

I took time out from yesterday, where I was supervising placing a well back on production. A sign of the times. I was taking the place of three different supervisors and foremen who have either retired or had to be laid off during the last 3 years of depression.

CIPA is thankful for the concern shown by the President and his administration, as shown in his energy tax incentive proposals, and of the numerous members of Congress who have drafted and supported H.R. 664, the Domestic Energy Security Act, and H.R. 658, the Energy Security Incentive Act.

CIPA endorses the positions of IPAA, API, the service contractor representatives. Their national perspective does represent many CIPA members who also belong to these associations.

However, we feel it necessary to be here today to provide what you might call a California perspective. We feel that we are not only important to the oil and gas industry, both as producers, being now the third-largest producer in the United States, but also, the single State of California is the third-largest consumer of energy products in the world.

We also have the largest congressional delegation, and thus, we feel it necessary to communicate to our 45 Members as to the severity of the problems that we face.

California also is the largest source of tertiary reserves that many of the proposals address. But also, we face a lower-than-average crude oil price, and thus have been more severely impacted than other areas of the producing States in the industry.

Now crude oil prices in California, as I have mentioned, are significantly lower than what you might read about in benchmark West Texas intermediate. If you take a posting today you must subtract $5 a barrel for gravity corrections because we are blessed with that smelly, thick, black oil.

And you must subtract another $2.50 per barrel for the regional variance. Yes, California is a net importer, but with Alaskan crude passing by our shores, overall, the region is a net exporter of crude, and thus prices are kept well below the world market level.

A look at 1988 does not reveal a healthy picture, and maybe it is good to look at a specific region or specific operators to apply definition to some of the generalizations you have heard from the national representatives.

Average prices in California for 1988 were $9.60 a barrel. Operating cost and royalty burdens remained high, somewhere between $9.50 to $10 per barrel, not much room to make a profit.

High costs continue. Tertiary recoveries in the form of steaming are expensive. Environmental compliance is very necessary and we are supportive of it, but it comes at a cost.

Yes, increasing prices are a relief. We just posted at $13 a barrel, and I can say that now, in my company, and I know in other companies, that we can restore the pay cuts to, finally, 1985 levels. We can conduct deferred maintenance and place additional wells back on production.

Will it last, and is it sufficient? I fear that it is not. Thus the energy tax incentives, as proposed, are a step in the right direction, and I commend the administration on the recognition of this very severe problem.

However, they are geared primarily toward exploratory drilling, or wildcatting, if you will. H.R. 664 and 658 provide additional and stronger support that is very critically needed, and just on two particular items of note, I would like to stress the importance of production credits for marginal wells to keep them from having to be abandoned.

We would suggest that $1 per barrel basis for the incentive be considered for simplification rather than just based on a percentage of the expenses.

Further, we would like to see consideration of environmental credits because they are needed, we do need to comply, yet they are a very costly item that stands between us and our continued operations.

Again I, and the California Independent Petroleum Association greatly appreciate being able to be here today to testify before you, and we are appreciative of your support.

[The statement of Mr. Hall follows:]

Testimony Before House Ways and Means Committee

On the President's Budget Proposals for Energy Tax Incentives

April 12, 1989

by James C. Hall, President

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I am James C. (Chris) Hall, President of Drilling & Production Company, an oil and gas producer in California. Today I am also representing the California Independent Petroleum Association (CIPA) as its President. The association is composed of 700 members who are independent crude oil and natural gas producers, royalty owners, supply and service companies doing business in California.

CIPA appreciates the opportunity to testify about the current state of the oil and gas industry (with specific emphasis on California) and the effects that the Administration's energy tax proposals could have. We sincerely appreciate the concern shown by the Administration as well as that of the many Senators and Representatives who have backed proposed legislation such as S. 232, H.R. 664 and H.R. 658.

We are supportive of the position of the Independent Petroleum Association of America (IPAA), which has fairly represented the national concerns of independent producers. Many of our members are also active members of the IPAA as well. Today, I will provide you with comments that pertain to California production where economic conditions are especially severe.

INDEPENDENT PRODUCERS REVENUE CONTROLLED BY THIRD-PARTY POSTINGS

First, we need to define the typical independent producer that CIPA represents. By the existing tax code he is involved in the oil and gas industry, but does not have refinery capacity exceeding 50,000 barrels per day nor retail sales exceeding $5 million per year.

More typically, the independent producer is not an integrated company. He is a producer only and does not have downstream refining and marketing income; his profit is made at the well head; the price he gets is tied to the crude oil postings of the major integrated companies. Currently in California four integrated refiners and two independent buyers set the price of crude.

CALIFORNIA HAS VAST CRUDE OIL PRODUCTION FUTURE

California is a major player in the nation's energy supply. With production of about 1,054,000 barrels of oil per day, it is now the third largest producing state, behind Alaska and Texas.

With regard to future recoverable reserves, California has the single largest source of known additional reserves in the lower 48 states and has 90% of the produceable U.S. tertiary oil. A 1975 study by a Department of Energy consultant estimated that 20 billion barrels of heavy crude could be ultimately recovered from known California reservoirs if oil prices were high enough ($18.00 per barrel in 1975 dollars) and/or if the tax code provided the right incentives.

Today, 70% of the oil produced in California is classified as heavy oil of 20 degrees API gravity or less. Twenty years ago, only one-half of the oil produced with heavy oil. The average gravity has declined from the high 20 degrees in the early 1920's to about 16 degrees in 1987 as the known light oil reserves are produced and .pa depleted, leaving only the more expensive heavier crudes to produce.

Independent producers themselves currently produce about 28% of the state's production, operating many of the marginally economic fields.

California also is the third largest consumer of petroleum products in the world, behind only the United States and the Soviet Union.

CALIFORNIA PRICES LOWER, EXPENSES HIGHER

In the last 20 years, crude oil prices in California have been depressed below equivalent crudes elsewhere in the country due to the heavier oil produced and primarily since 1978, the abundance of Alaskan production landed on the West Coast.

Currently, prices are about $7.50 below West Texas Intermediate postings ($5.00 for gravity and quality corrections and $2.50 due to regional price variances). Hence, the producer/operator has been severely affected by the continuing depression in the oil patch. A typical barrel of 13 degree API crude that sold for $21.80 in 1985 averaged only $9.60 during 1988.

With typical operating costs ranging from $9.50 to $10.00 per barrel (including royalty payments), there is little if any profit for replacement of reserves or implementation of enhanced recovery projects.

In comparison with onshore producers in other parts of the nation, the California producer is especially burdened with high operating and development costs caused by the strong state economy, large environmental hurdles, and a negative public sentiment against the oil and gas industry. CIPA members operating in California and the mid-continent estimate that their California operating costs are 25% to 33% higher than in their mid-continent operating costs.

THE PRESIDENT'S ENERGY TAX INCENTIVES NEED TO BE BROADENED

The Energy Tax Incentives are a step in the right direction; President Bush and his Administration are to be commended on their recognition of the problem. However, primarily geared toward exploratory drilling, these incentives will do little to mitigate the nation's energy crisis.

The provisions of S. 232, H.R. 664 and H.R. 658 provide additional and stronger support that is critically needed if the continuing decline in domestic production is to be even slowed, much less turned around.

In reference to the President's proposals:

a.) The 10% tax credit for exploratory intangible drilling costs in a property not previously drilled and not located next to another producing property is too restrictive; it fails to recognize that most possible reserves are to be found in known geologic basins. This also does not recognize the importance of the drilling of development wells towards increasing and then maintaining production.

b.) The 10% tax credit for new tertiary enhanced oil recovery projects would exclude the majority of existing fields where some limited EOR has already been applied (i.e.: cyclic steaming of individual wells) that are prime candidates for larger projects (i.e.: steam floods). The large investment of capital would not be warranted without some measure of tax credit.

c.) The elimination of 80 percent of current Alternative Minimum Tax (AMT) preference items for exploratory Intangible Drilling Costs (IDC's) needs to be similarly extended to include development costs as well.

d.) The elimination of the "transfer rule" and increasing the percentage depletion deduction limit for independent producers to 100 percent of the net income of each property are very beneficial, allowing some marginal properties to be produced at lower cost by an independent producer, thereby increasing ultimate field recovery.

RECOMMENDATIONS FOR EXPANDING CREDITS

If the desire of the administration, and Congress, is to ensure a stronger domestic industry and hence, reduce the level of foreign oil imports, then I would like to recommend several additional suggestions to make the proposals more effective:

a.) The 10% tax credits are too limiting; only more substantial allowances such as the 20% provided by H.R. 664 and H.R. 658 would have a greater, measurable impact in slowing the decline of U.S. production.

b.) Consideration needs to be given to production credits such as those proposed in H.R. 664 and H.R. 658. Without such provisions, the loss of production from the abandonment of marginal fields will greatly offset the new reserves identified through exploratory drilling.

It is recommended that these not be tied to costs but rather be applied on a per barrel basis in order to simplify accounting and reporting requirements. Without this provision, the tax incentives alone would do little to maintain production from marginal fields with little or no profit margin at today's crude oil prices; they would benefit primarily larger companies (especially major integrated entities) that could apply the credits against downstream profits.

c.) California is perhaps more sensitive to environmental issues than most other states. In this regard, we work with our member producers to ensure the compliance with existing and forthcoming regulations. We encourage the consideration of tax credits (like those proposed by H.R. 664) to assist producers towards implementing required compliance programs. Without such assistance these costs could cause the premature abandonment of existing producing fields/wells.

SUMMARY

In conclusion I respectfully would urge this committee to not only consider the President's energy tax incentives, but also consider enlarging them to encourage continued production from high-cost stripper and marginal wells, and to assure maximum development and recovery of oil from our nation's vast heavy oil reserves.

On behalf of the members of the California Independent Petroleum Association, I appreciate the opportunity to make this presentation before you today. We are available to assist you in any way.

I would be happy to answer any questions you may have.

Mr. **Andrews**. Thank you very much. I just have a few initial questions. Let me ask the panel as a whole this question. The committee, as we look at the need for additional revenues, is going to be very critical of incentives that cost the Treasury money, and I think one of the questions my colleagues have asked me, and others that have come before the committee is, how, in this instance, can the committee be assured that the benefits of these tax credits will be plowed back into exploration and development?

Mr. Singer, do you want to take a shot at that?

Mr. **Singer**. Mr. Andrews, Mr. Chairman, historically, the independent sector has been responsible for reinvestment of well over 100 percent of wellhead revenues. That is because of outside capital that is brought in.

The legislation which we specifically endorse is well crafted to bring in outside capital. It is well constructed, so that it addresses a specific problem, and the historical pattern should be ample evidence that independent producers cause a substantial increase in their own profits to be reinvested, more than they bring in themselves, but create an environment for investment for other individuals, and I think that we can stand on the record, probably.

Mr. **Andrews**. Well, I would suggest that attracting capital right now is one of the cruxes of your problem, isn't it? Give the committee your observations. What is the situation right now in terms of getting capital into the business?

Mr. **Singer**. Getting capital into the business is a very serious problem and it has been compounded, in part, by some inadvertent problems that have arisen as a result of the Tax Reform Act of 1986. In two particular ways there are problems.

One is, inadvertently, I believe—I am sure it is not an intended result of the working interest exemption from the passive loss rules—the oil and gas producer finds his business somewhat compartmentalized. People who are not already in the oil and gas business have difficulty getting over the barrier that is created.

Second, the alternative minimum tax, the result that is imposed on the oil and gas industry, in part by the narrowing of rates which apply to all taxpayers, and in part by the fact that we have two particular items that are preferences, that are peculiar to our industry, is a very strong disincentive.

If we have a credit, and we have a credit which is crafted to be applicable against the alternative minimum tax, then we can bring people who would be in serious preference situations should they decide to start investing in the business, we suddenly have some basis to bring them in, without immediately running into the disincentive aspects of the alternative minimum tax.

Mr. **Andrews**. Would anybody else on the panel like to comment on that? Mr. DiBona.

Mr. **DiBona**. Well, actually, these proposals cut two ways. They not only make it easier to obtain capital, but they also increase the potential return of a particular project. So they encourage—they make it possible to undertake exploration and production efforts that otherwise would not be economically feasible.

If you look at the recent drilling data, you will find that we are finding more oil per well. That is not that the prospects are suddenly better. It simply means that there are some that are no longer economically possible, and therefore, we cannot undertake them.

But with incentives of this kind you will do the kinds of things you did a few years ago, that you no longer can do. So it works on both ends of that spectrum. It makes cash more available, but it also makes it possible to undertake projects that otherwise would not be undertaken. The kinds of resources that we will employ to do that will be resources that would otherwise not be employed.

The unemployment in many of the areas of the country where these kinds of projects would be undertaken are just plain unemployed, so it is going to be a net benefit to the Nation if they are so used and not tracked from some other possible investment.

Mr. **Andrews**. In other parts of the world where they have used these kinds of tax incentives, what have been the results? In particular, the United Kingdom has more generous tax incentives for the oil and gas industry than does the United States. Tell me what the effect has been. Mr. DiBona, would you care to comment on that?

Mr. **DiBona**. Well, we don't really keep the records outside of the United States, but it is my understanding that in the United Kingdom they were able to stabilize many of their operations by adjustments to the way in which they taxed and treated investment, because much of it is contracted with the government, so there were changes in some of the royalty arrangements. Similar things happened in Canada and, therefore, there was much more stabilization in Canada of rig counts than in the lower 48 States.

Mr. Woods would like to talk about that.

Mr. **Woods**. I might just add that Canada, in the package of my presentation you will find some slides or graphics depicting the rise and fall of the Canadian rig count, and you will notice the demise of the rig count at almost precisely the expiration of their various incentive programs that they have had come and go in Canada, so it has worked sufficiently there.

The United Kingdom, interestingly enough, during this whole, what I call the holocaust, 1981 to 1986, in my business, as a general rule their activity levels have remained fairly stable.

Mr. **DiBona**. I don't have anything further, Mr. Chairman.

Mr. **Andrews**. The gentleman from Texas, Mr. Archer.

Mr. **Archer**. Thank you, Mr. Chairman.

Mr. Singer, you alluded a little bit to the alternative minimum tax and its negative impact. Could you be just a little more specific in telling us why eliminating the preference for IDC's and depletion from the alternative minimum tax are critical to independents?

Mr. **Singer**. With the narrowing of rates, Mr. Archer, we have run into a situation where, because of the relationship between the marginal rate of 28 percent and the alternative minimum tax rate of 21 percent, the relationship is so tight, that if you have any substantial amount of preferences relative to your taxable income, you are going to be in alternative minimum tax. Many taxpayers, small producers, have relatively small level of taxable income now because of product prices, but they still have a fair number of preferences, because we have with IDC's and excess depletion defined preferences that are peculiar to our industry.

When you reach the point at which you should go into the alternative minimum tax, it becomes punitive to continue to grow, so you simply stop. You either run into a situation first where you get no benefit for spending a dollar, no deduction whatsoever, even though you have gone out and spent the money, and it is a hard dollar, or you can reach a point very quickly in many instances where you not only get no benefit for the deduction, but you have to pay 21 cents for the privilege of having already spent the dollar. That is so punitive and the disincentive is so high that most producers, small producers particularly, simply quit drilling and you lose the whole level of activity and all the exploration and production and taxable activity that would flow from the discovery reserves that would result. That is disincentive that is not, I don't believe, faced by any other industry. It is so punitive that this is a critical issue that has to be addressed by the legislature.

Mr. ARCHER. Well, I certainly hope we can change that.

Mr. Woods, what would the incentives that you support mean in terms of additional activity if they were adopted?

Mr. WOODS. I made one very basic calculation that I am familiar with that is on fairly solid ground. We know that in the United States, to drill and equip wells, that we will spend approximately $10 billion this year. That is just on the EMP side. That does not include the production side of the business. You take that $10 billion and roughly 20 percent credit, we are talking of a couple billion dollars, and our drilling model that we have at our company by taking the various forces that impact our business with that kind of additional funds, we believe we would increase the U.S. rigs about 200 rigs, so that would be 200 on 800, is roughly a 25-percent increase in activity.

Mr. ARCHER. How many jobs would you estimate that would create?

Mr. WOODS. I believe in the associations that I represent directly would be somewhere around 10,000 jobs, but that doesn't include the manufacturers behind them and the clerical and the engineering and the support. I am just talking about to drill and equip the wells.

Mr. ARCHER. What impact would you think that would have on future energy reserves?

Mr. WOODS. Well, obviously, that gets into various factors. I can't help but believe that would have a positive impact, but there are so many things we would have to consider, the mix between exploration and development, the technology that we have added, the success rate, the rig efficiencies—all of that working together would tell me that we would have a fairly positive impact.

Mr. ARCHER. The price of oil recently has been around the $20-a-barrel point, and that is up significantly from what it was——

Mr. WOODS. That's right.

Mr. ARCHER [continuing]. Particularly when one examines percentage. Would you tell the committee why this in itself does not drive the additional activity that you have suggested would occur from these new tax incentives?

Mr. WOODS. Well, that's correct, the West Texas intermediate is between $18 and $20 and has been there now for the last couple of months, and that is a high, it is a high that we have had here in the past year or so. What we must remember, however, is just 4 months ago it was $13, and if you are in the business and you are making economic studies trying to work within a range of $13 and $20 to make a good solid investment decision, you are somewhat leery. So, I think there is a wait and see attitude on the part of the $20.

Mr. **DiBona**. I might try and answer that, too. These decisions are long-run decisions, they are not made on the basis of the current price, but of the expectation of the price over the period when you would be producing the property. All you can say about the current price is that it is highly volatile, so what we are living with is terribly volatile prices that range recently from highs of $20 to lows in the order of $10 and $12, and it is very difficult to make decisions on that basis. This kind of proposal would give you a lot more confidence to move forward.

Mr. **Archer**. You have made the point that the country's national security depends to a great extent on our reserves, our domestic reserves. National security does not just mean military security but also economic security. Since our reserves, I agree, are that important to national security, how would you address the allegation that is made by many that we ought to protect those reserves and not develop and produce them, but keep them in the ground and depend more on foreign oil?

Mr. **DiBona**. I think what that ignores is the lead time to produce oil and gas in the United States, and it also ignores the fact that many of our current wells, if they are not continued in production, will never be restarted again, so you have some dead loss if you let those go. They would not be something you could recover.

With regard to the new areas of exploration or new production, the problem is we would find ourselves increasingly dependent on OPEC. We already see that happening. We are approaching 50-percent dependence on imports. That is going to rise with the best of our efforts. It will rise that much faster. OPEC would very soon be back in the driver's seat.

Currently, it is hard for them to manage prices, but if we demand more of their oil, so that it is easy for them to make agreements and share any cut in output to push prices up, they will be able to do that. That could happen within 2 or 3 or 4 years. At that point, we would be open to cutoffs of oil, sudden rapid prices, gasoline lines and all of the problems we saw in the seventies.

If we then try to deal with that problem by developing our own oil, it will take us, as it did in the seventies, almost 10 years to redress that balance, and so what we do is we invite that kind of problem.

The trouble is we can't be positive that OPEC is going to continue to deliver oil at low prices, and in fact we give them an incentive not to when we choose not to develop our oil.

Mr. **Archer**. Mr. Woods, would you like to add anything to that?

Mr. **Woods**. Yes, I would say this: My concern would be basically what Charlie says, but also along the line that, yes, we had domestic reserves, but they are no good unless we can get them out of the ground, and to get them out of the ground you need this infrastructure that I described earlier in my presentation. You need these drilling contractors and the Baker-Hughes and service companies of the world.

If we continue to let the activities slip away, we are slow but surely—the infrastructure is fading away, and then when we need this oil, to respond in the reasonable length of time might be extremely difficult.

Mr. **Archer**. You have made a point that the capacity of your industry is limited. How much activity would you estimate you could handle if the incentives were in place?

Mr. **Woods**. It is in my written presentation, I go into the fact, I think the numbers were 1982, we had roughly 5,600 rigs available for work in the United States. The reported numbers today are somewhere around 2,000 to 2,500. Probably, in reality, due to the cannibalization and the lack of funding for maintenance, I think we would probably be hard-pressed to muster, say, a total of 1,500. So, on that basis, if we only have 1,500 available to go to work today, then you have to look back at the service companies and the inventory situation, drill pipe, et cetera, and just how much of that is available, and I would guess that we would be hard-pressed in the service industry to supply at this time much over 1,300 to 1,400 rigs.

Mr. **Archer**. Now, what about trained personnel?

Mr. **Woods**. That would take time. As I mentioned earlier, a lot of our staff, a lot of our people have left the industry, it takes time to bring them back up to speed. Like I say, to get competent field hands to actually stand over the rigs and monitor the equipment, you are probably talking 2 or 3 years to bring them up to full speed.

I think it is interesting to note that the statistics on petroleum engineers, in 1982 I think we had something enrolled in the United States of around 10,500 or so petroleum engineers. That is down to a couple of thousand in 1988, and of this number less than 300 are freshmen.

Mr. **DiBona**. Another way of answering that question is to just look at the domestic exploration and production expenditures by the numbers we keep for the leading oil companies, but it is reflected perhaps even more dramatically on the independent side.

In 1981, they peaked at $26.3 billion. By 1985, which is a little over 3 years ago, they were down to $19.8 billion, and that is a drop of 25 percent. By 1987, that is in a 2-year period, they fell to $9.6 billion, half of the 1985 level.

Mr. **Woods**. So, in very recent times, you had a 50-percent decline in expenditures, and presumably some substantial part of that you could get back on line if there were an incentive to do so or a possibility to do so.

Mr. **Archer**. Mr. Chairman, you have been very generous with me on the time and if I could have your indulgence for just one last question to Mr. DiBona. It is not germane to tax policy but it is germane to energy security. I would like to ask him his feelings about the Alaskan oilspill and what relationship the risk of further oilspills there is to the possible drilling in ANWR.

Mr. **DiBona**. Well, I think everyone in this industry feels that this was a tragic and unfortunate occurrence; we certainly wish that it had never happened, and the principal interest is to try and clean that up as quickly as we can do so.

With regard to its implications, it really was not related to activities on the North Slope, which have been carried out with great skill and with no damage whatsoever to the environment. The few spills that have occurred up there have been very small and 100 percent of the oil has been picked up.

With regard to this shipment—and this was a shipment of oil at sea—there are hazards. This is not the largest spill that has ever occurred, it is the 21st largest spill. It is the largest in U.S. waters, but there have been 20 spills larger than this.

If we choose not to develop the ANWR, what it means is we will not avoid shipping oil into the United States, we will simply be shipping it in foreign bottoms from places like Saudi Arabia. But unless we give up using fuel in this country, we are going to have to bring it in, if we choose not to develop the domestic production, and the hazard there will be just as great as shipping it down.

Let me add one other thing about it. There is no doubt that the immediate effect of one of these spills is very dramatic and very harmful to the environment. But in the history of large spills of crude oil on the ocean, all of the previous cases in a relatively short period of time have resulted in a situation where there is no permanent ecological damage. That is true of the spill, for example, off the East Coast of the United States, which is the second biggest spill, the *Argo Merchant,* which broke up on Nantucket Shoals and the oil went over the George's Bank at the most critical time in the spawning of haddock and cod. There was no diminution of the catches that year. None of that hit shore.

The *Amoco Cadiz,* which was a spill six times as large as the spill up in Prince William Sound, hit the coast of Brittany. There was a major cleanup action, but within 3 years the ecological system had totally recovered, with the exception of a couple of small crustaceans which are now back to normal levels. The fishing was normal within a couple of years in that area.

So, it is possible, with effort, to recover from these and the ocean itself does a great deal. I mean there is oxidation and breakdown of the oil that occurs even in cold waters, and that, I think, is probably already starting to occur.

Mr. ANDREWS. Would the gentleman yield, Mr. Chairman?

Mr. ARCHER. I yield.

Mr. ANDREWS. I want to yield to our other colleagues that are not from Texas, give them an opportunity to ask a few questions. But I did have one more question that Congressman Archer had asked earlier, and I would like to ask you to expand on.

Surely, it has to be a goal of all of us to have some kind of constancy of price, some way to anticipate the future. As you said, Mr. DiBona, this is such a volatile situation, the price goes to $22 a barrel next week and there is no way to anticipate what that price is going to be. If the price were to go up, does it have to stay at a certain level before we can see a difference in rig count, in jobs, especially for independents out there? The simple fact that the price goes up to $20 a barrel for a week and then slips back down a few dollars a barrel, is that enough to encourage people going back to work again in the oil patch?

Mr. SINGER. I think that the price has to stay up for an extended period of time before it serves any purpose relative to the——

Mr. ANDREWS. What is an extended period of time?

Mr. SINGER. An extended period of time would probably be well over a year, because what we are talking about is figuring out a way to get investment capital into the industry. Investment capital is not available from conventional lending institutions for exploration projects. We have historically been able, as producers, to borrow against reserves. We can't do that when prices are volatile, because there is no accurate way to judge what those reserves are worth. Lending institutions are very leery. That process would probably take a 2- or 3-year stabilization period before lending institutions would do that.

For investors, it might take a slightly shorter period of time.

The benefits from the legislation that you gentlemen have proposed are clear and can be evaluated by individual investors and that creates a climate where people can understand what they are getting. It does not stabilize price, and none of the legislation that is being proposed addresses that issue, but it at least creates a clear understanding and expectation as to what the benefits might be from an investment decision.

Mr. ANDREWS. I want to yield to Mr. Thomas.

[Mr. Thomas submitted the following statement:]

Statement for the Record
The Hon. Bill Thomas
Committee on Ways and Means
April 12, 1989

I want to commend Chairman Rostenkowski for giving the Committee this chance to examine President Bush's tax incentive proposals for research and development and other matters. I am especially interested in the President's oil and gas proposals. The information we get today will give the Committee a chance to seriously reconsider our energy policy, a view I am sure our colleagues from Texas and other oil producing states will support.

Both parties' presidential candidates made energy security part of their 1988 platforms for a reason: the producing side of our domestic industry has had a lot of trouble over the past three years. Domestic production has fallen while oil imports--now approaching 50% of our domestic use--increasingly dominate U.S. energy supplies. OPEC's internal political squabbles created enormous problems for domestic producers two years ago, and domestic producers are no less vulnerable to international pricing matters now.

Congress needs to rethink the incentives provided to produce oil and gas now in order to prevent our production problems from becoming worse in the future. If we fail to provide appropriate incentives, we risk having more wells shut in, preventing the U.S. from being able to recover resources that would otherwise be available.

President Bush's proposed marginal production and exploration and development credits, as well as his proposed modifications of the percentage depletion rules, are excellent beginning points for discussion of what our oil and gas tax policy should be. I am pleased that the President's experience as a producer in Kern County, which is in my congressional district, is reflected in his proposed incentives for the production of heavy crude.

I hope, however, that the Committee on Ways and Means will get an opportunity to look at other proposals such as those included in our colleague Congressman Archer's bill, H. R. 664. H. R. 664, of which I an original cosponsor, proposes modifying the alternative minimum tax and other tax influences on domestic production so that American producers have incentives to devote scarce resources to producing oil and gas. What we do today will influence domestic production tomorrow, and H. R. 664's broad incentives package would do a great deal to stabilize our domestic energy industry.

Mr. THOMAS. I thank the chairman very much. I want to thank the panel and those folks you represent for the cooperation of the industry in putting together the material that has evidenced itself in H.R. 658 by the gentleman from Texas, Mr. Andrews, and H.R. 664 by the gentleman from Texas, Mr. Archer.

Perhaps I should be down there on the panel, rather than up here, because I want to talk a little bit, instead of asking some questions first. The real concern I have involves the tragedy in Alaska and whether it is going to define energy policy. It was a shipping accident. We do not allow an airplane crash to define transportation policy. Instead, one may pause and reflect, modify, and then move forward—there is grave danger, as was indicated in the response to the question by the gentleman from Texas, Mr. Archer, that the ANWR may not be decided on the basis of a shipping accident, and that is really unfortunate.

I had some hope, coming out of the 1988 Presidential election, since both the Republican and the Democratic candidates for President had some oil incentive proposals in their respective party platforms.

I think what members of this panel—and I am speaking to the record now—and Members of this House need to understand is that through the decade from the mid-1970's to the mid-1980's, there was a significant reversal of Government involvement in the financial end of the oil industry. From this committee alone, the 1986 bill, passive loss, the alternative minimum tax has been exemplified.

But in addition to that, the windfall profits tax in my area devastated local less-sophisticated refiners and required burning of crude in situ for economic reasons. That was an economic distortion by Government. I am not saying that Government has not been involved in the economics of the oil industry from the beginning. What people have to understand is that laws like the windfall profits tax and the requirement that the Alaskan oil has to come to California have their effects. The gentleman, Mr. Hall, representing CIPA, indicated that California is the third largest governmental consumer of energy in the world, and would be a net importer were it not for Alaskan oil. That has an impact on price in California. Price obviously, as indicated by the gentlemen on the panel, affects the ability to produce.

These were governmental policies. When I see questions from the staff or others as to why we should be attempting to create incentives—what I saw in the candidates' platforms were restorative provisions. My concern with them and the industry's concern was that they tended to be temporary and perhaps didn't go to the long-term heart of the matter, as you folks have indicated.

I have problems with the current administration when they define heavy oil as 16 specific gravity, rather than the industry definition of 20. Given the kind of oil that we have in California, that was a significant blow to cost supports at the time.

Fundamentally, to respond to the question of why should we be dealing with these revenue measures in heavy deficit periods, I would offer the response that you do not create wealth by buying oil from someone else. The idea that you do not utilize your resources to produce wealth, which allows you then to deal with other nations in terms of a trading arrangement is in large part where we are with some of the Japanese. We are buying the product they are making. We can't run a total service economy, and creating oil is creating wealth. This type of capital goods is important to this country, always have been and, as long as we have it available, always will be.

The difficult thing I have is trying to explain to people that, yes, we have 45 members from California and we produce more oil than just two other States. But this one Member himself has a district which produces more oil than the entire State of Oklahoma. If my district were a State, it would only be behind Alaska, Texas, and Louisiana. There are 44 other members of the delegation whom I need to convince that this question is important.

How do you save money by spending money—which is always an interesting question? Ask yourself, what would be the production loss if all of the stripper wells, as defined, were shut down tomorrow? Does anybody have a rough idea of the barrel equivalent loss if we shut strippers wells tomorrow?

Mr. SINGER. I can give you one answer, Mr. Thomas; that is that the average well in the United States produces approximately 14 barrels.

Mr. THOMAS. The normal definition for stripper is anything under 10 barrels?

Mr. SINGER. Ten barrels.

Mr. THOMAS. We are talking about fairly marginal production here. The point is, if you don't have an incentive to keep it going, if economically you can't produce it, you shut it in. What we are doing is making sure that we continue production in a vast number of wells that are currently producing in the United States.

Mr. SINGER. Well, the problem that you have is when you shut in wells you have no legal right in many instances to retain production on the property. When you shut in wells for an extended period of time, you lose your leasehold rights, so it is not a question of choice.

There is some confusion when they talk about turning to reserve when we are ready to turn to them between concepts such as the strategic petroleum reserve or SPRO, which is actually produced oil that is simply being kept in a reservoir that can be tapped and oil which is reserves that are not produced, have not previously been produced and cannot simply be turned on and off. That confusion of using the same word in both instances works to our serious disfavor in terms of people understanding access to those reserves.

Mr. THOMAS. If I might expand on that briefly—and this is not going to be Geology 101—but one of the things I try to do is get people to look at a core sample and explain to them that it is oil. They hold it in their hand and see that it is a rock. Most people I think believe that the typical oil reserve in situ is a reservoir in which you drill and stick a straw in it and pull it out. This kind of oil reserve is the strategic reserve. I have some question about these salt domes from which you pull oil out rapidly.

The largest reserves, as Mr. Hall indicated, in California, are heavy oils which have to have some kind of secondary or tertiary recovery procedure applied to them to remove the heavier oils. Once you begin that process, if you back down on production or cease production, you lose significant potential production from those wells.

We are talking about restoring incentives that have been removed in a number of ways over the last decade, so that we can continue to maintain the production that we have and produce the capital, as was clearly laid out by you gentlemen, to make sure that we can continue to drill those wells that will produce oil in the future.

The oil is out there. For those environmentalist friends who are concerned about the offshore question, what we ask is how about some incentives to produce the oil that is on shore. There is plenty of potential on-shore capacity. It is a question of economics.

What we are trying to do is redress slightly the imbalance that has occurred in part by the world market, which is controlled by governments, but also in part by the very actions of this body in various ways over the past decade.

So when people ask the question why are we talking about tax incentives, to a very great degree I believe we are talking about restorative provisions which put us back in a position where all of those rig numbers and all of those people that Mr. Woods and others discussed who are not at work can go back to work. Why? To produce wealth.

Thank you, Mr. Chairman.

Mr. Andrews. Thank you. The gentlelady from Connecticut.

Mrs. Johnson. Thank you very much, Mr. Chairman. I appreciate the clarity of the presentation of the members of this panel. I do not represent oil producers, but I do represent a part of the country that is very dependent on imports. As a new member of this committee, I may have a lot to learn, but it is a subject that interests me.

I was interested in your comments, Mr. Hall, in regard to the last page of your testimony which concerns the importance of tax incentives to maintain marginal fields. Some of the preceding comments make it a little clearer why it is important to maintain marginal fields rather than allowing them to shut down.

You go on to say in your last point that you also need tax incentives to deal with the cost of meeting environmental requirements, both legal and regulatory. As those environmental requirements increase—and I would expect that they will in the review that will ensue in the next year or two—where do we reach that point where we can afford to meet the environmental regulatory burdens for small wells?

If you are already pricewise up to $14 a barrel to break even in 10 barrel stripper wells, what are the implications of this environmental issue?

Mr. Hall. I think maybe one thing to recognize—and it is something we have so far not mentioned and I think most of you recognize—that we talk about incentives, and they may be what is currently achievable. They are sort of a minimum that is necessary.

I mean, in real retrospect, it sort of gets through to your question. There is nothing that would be better for the industry than higher and more stabilized prices. And as we talk about what is needed and how long would they have to remain, we would not have to be talking about some of the issues that we are considering today.

In reality—and the environmental incentives are part of this—we are talking about a portion of the industry, of keeping that employed, keeping it operating, and keeping wells on production. So that we can maintain some of the production of this country and the vitality in the industry to carry out the OR projects.

Now, the environmental concerns are becoming with each year an increased cost item, and it is something that we with our members stress very strongly to ensure that they are in compliance with, it is very much a part of doing business. Being a high ticket item, it is one of the major items that will decide whether or not a company remains in business and whether or not it continues to produce wells.

I might mention that somewhat of concern, a personal observation, that just over the last 6 months, there have been an appallingly larger number of wells that are being abandoned as opposed to left idle with hopes of future production. Part of these are out of environmental concerns, downstream later remedial work that may have to be done, and all of these are a cost item.

Without some consideration of incentives in this area, they themselves may become a factor for abandoning of wells that could be producers and should be producers and thus in our consideration are as much of an item that should be considered for incentives than just about any other.

Mrs. JOHNSON. Thank you. That is a very difficult issue.

Mr. JACOBS [presiding]. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman.

I am sitting here this morning—and I want to thank the panel—getting a lesson about the oil industry, but I have no further questions nor speeches on the subject. Thank you.

Mr. JACOBS. I suppose the panel has completed their testimony, unless there are any omitted questions. In any case, we thank the panel for its contribution to the record and invite the next panel to come up and take your places.

This panel consists of those on the list, the Council on Research and Technology, represented by Dr. Roland W. Schmitt; the Electronic Industries Association, represented by Peter F. McCloskey; the Chemical Manufacturers Association, represented by Richard A. Overton; and the Emergency Committee for American Trade, represented by Dr. Robert McNeill.

Gentlemen, I assume you already know the 5-minute rule. We try to observe it. Please proceed in the order in which you are listed.

STATEMENT OF ROLAND W. SCHMITT, PH.D., CHAIRMAN, COUNCIL ON RESEARCH AND TECHNOLOGY [CORETECH], AND PRESIDENT, RENSSELAER POLYTECHNIC INSTITUTE, TROY, NY

Mr. SCHMITT. Thank you, Mr. Chairman.

Mr. JACOBS. You can summarize and hand in your statements. Conciseness is regarded as brilliance at this committee.

Mr. SCHMITT. Thank you, Mr. Chairman.

My name is Roland W. Schmitt. I am president of the Rensselaer Polytechnic Institute and chairman of Coretech.

Coretech represents 51 companies, 77 universities, 18 trade associations, 7 research institutes, and 9 affiliates. We have one very simple message today and that is in the area of research and development; what we want, what we need, are predictable, long-term, and stable policies.

Now, what this means in terms of the issues before this committee are first of all a permanent solution to the 861-8 issue; second, a permanent basic research credit; and third, a permanent R&D tax credit.

I am going to address items Nos. 1 and 2. Pete McCloskey of the Electronics Industry Association will address item No. 3.

Let me comment on the need for stable policies. I spent 36 years in research and development in the General Electric Co., 9 of those years heading GE's corporate research and development. So I am quite familiar with what makes good R&D go and not go.

A substantial part of research and development, virtually all of research and development, is a multiyear effort. I have many examples. One that we worked on for some 13 years was a new type of polymer. Another one, a new form of medical diagnostics, for 6 years.

In the light of that, off and on public policies, policies that lapse, policies that are extended for only brief periods of time, do not correspond to the realities of R&D, the nature of R&D, and the needs of R&D.

As it applies to R&D 861-8, as you know, has been addressed five times by this committee in 10 years. The last time only a 4-month extension of the moratorium was given. The basic research credit first came up in 1986, and is due to expire at the end of 1989. The R&D tax credit was enacted in 1981. It lapsed in 1985. It has been extended twice, it too will expire at the end of 1989.

It is, in short, a distressing history. It is poor public policy that is out of sync with the needs and nature of research and development. So we wish to urge strongly a set of permanent solutions. Basic, stable policies are needed.

Let me remark on 861-8 for a moment. Here the need for stability is especially strong. The regulation, as you know, was first proposed in 1977, and that set off a 12-year roller coaster ride. The regulation itself is blatantly wrong-headed. It treats some domestic R&D as if it were performed abroad. The United States is the only significant country to do this. It is a disincentive, a penalty for domestic R&D. Domestic R&D expenditures should be treated as such.

Now, I realize there are people, critics of the moratorium, who say several things about 861. They say it is just a tax break. Frankly, that is not so. U.S. R&D performers need equal treatment with their foreign counterparts; 861-8 imposes a penalty tax on companies who do R&D in the United States; it is not a tax break.

R&D done in the United States is beneficial to worldwide business, critics say, so why shouldn't some of it be paid by them? Maybe we ought to encourage the growth of foreign business and not discourage it. International competitiveness based on domestic R&D is a much desired end. It is not something to be punished.

The critics also say the deduction lost to the United States can be recovered abroad. Let us examine that for a minute. It is an incredible claim. Think of the foreign tax agent. He says: You rent lab space in the United States, you buy equipment in the United States, you have a payroll of U.S. residents, they eat at local restaurants, they cash checks at local banks, they buy the toys for their kids at local stores, they pay U.S. taxes on wages and property, and you want me to allow those costs as a deduction in my country? It does not make sense. Instead, the foreign agent will say bring your R&D here for a deduction and we will add to that grants, credits, rent abatement, and other incentives.

I have had one American CEO tell me that a European government virtually extorted his company to do R&D in the foreign country, trading competitive pricing for R&D jobs. They do handstands in foreign countries to get R&D. We spend 12 years debating a policy to send R&D abroad.

The 861-8 is wrong, it is anticompetitive and regrettably it is in effect today. This really should be permanently resolved.

My final comments are on the basic research credit. Having been personally on both sides of the industrial and the academic interface, I am intensely concerned about public policies promoting the linkage.

At my school, Rensselaer Polytechnic Institute, almost half of our R&D is collaborative with industry, far above the national average. In the United States, academic research is a unique asset. We have strong academic research universities, tightly coupled to industry, different from Japan, which did not have that asset, different from Europe, which does not have a strong linkage.

Japanese corporations——

Mr. JACOBS. Mr. Schmitt, included in science is the science of mathematics. Your time has expired. We will get into questions in just a moment. If you can finish in two sentences, we will let you swipe some time from the next speaker.

Mr. SCHMITT. I was going to tell you Japanese corporations spend more in United States academic research than they do in research in their own country. So the conclusion basically is that we need stable, predictable R&D tax policy, and that is the main message we give to you today.

Thank you.

[The statement of Mr. Schmitt follows:]

STATEMENT OF DR. ROLAND W. SCHMITT, PRESIDENT OF RENSSELAER POLYTECHNIC INSTITUTE, ON BEHALF OF THE COUNCIL ON RESEARCH AND TECHNOLOGY (CORETECH)

Mr. Chairman and Members of the Committee:

My name is Dr. Roland Schmitt. I am president of Rensselaer Polytechnic Institute. I am here today in my capacity as the chairman of the Council on Research and Technology (CORETECH). I want to thank you, Mr. Chairman, for including me on this panel to address the President's FY90 Budget tax proposals on research and development.

CORETECH represents 51 Companies, 77 Universities, 18 Trade Associations, 7 Research Institutes, and 9 Affiliates. We come before you today with one simple, straight-forward message:

In the area of research and development, we want predictable, long-term, stable public policies.

This means:

- A permanent solution to the 861-8 issue;
- A permanent basic research credit;
- A permanent R&D tax credit.

The Need for Stable Policies

As the head of Research and Development for General Electric for 9 of my 36 years with G.E.'s R&D Division, I am quite familiar with the R&D enterprise in this country. At G.E., a substantial part of our research involved multi-year efforts. In fact, I can remember several significant projects that we worked on for 13, 11, and 6 years respectively. That is the nature of the R&D Enterprise. These time frames are typical of research projects across the country. Therefore, public policies that are on and off again, that lapse, or that are extended for a year or two at a time simply do not correspond to the true nature of the R&D undertaking:

- The 861-8 issue has been addressed 5 separate times by this committee in the last 10 years and the last time the moratorium was extended for only a 4 month period!
- The basic research credit was passed in 1986 for a 2 year period, then extended for a one year period and is now set to expire in December.
- The R&D tax credit was enacted in 1981, lapsed at the end of 1985, was extended for two years in 1986, was extended for another year in 1988 and will also expire at the end of this year.

This is a sorry history. This represents a public policy response that simply doesn't square with the need.

We urge you to respond with a set of permanent solutions. This committee will always have the power to fine tune the policy and respond to new developments as they occur. But basic, stable policies should be set so U.S. companies and universities are able to rely on them.

861-8

No where is this need for predictability and stability more apparent than with respect to the 861-8 issue.

Mr. Chairman, as you know, this issue began with regulations proposed in 1977. These regulations set off a 12 year roller coaster ride that still isn't over as we meet here today.

To make matters worse, those regulations were blatantly wrongheaded. They took the position that a portion of the R&D performed in America should be treated as though it were performed abroad. I understand there is a tax theory that a certain portion of American R&D accrues to the benefit of a company's foreign operations. You don't have to be a competitiveness guru, however, to understand that since the U.S. is the only country on earth that treats a portion of its domestic R&D as if it were performed abroad, it is a clear disincentive to those who want to locate R&D in the U.S. Simply, if the tax code tells you that a portion of your domestic R&D will be treated as though it were performed abroad, then it might as well be! If the U.S. wants to maintain -- or better yet -- increase its research force in this country, the government should clearly treat salaries for American PhDs and engineers, for example, as American expenditures -- because they are.

More importantly, these expenditures greatly benefit the U.S.:

- o U.S.-based R&D leads to the development of products that are predominately used by Americans;
- o Domestic research and development also produces American jobs, encourages collaboration between corporations and U.S. universities (which often results in corporate contributions to American schools), and trains U.S. scientists.
- o Because of the close link between basic research and eventual product development, domestic R&D results in more manufacturing of new and improved products within the U.S.

Over $60,000,000,000 was spent in the U.S. last year on R&D. The successful result of this R&D can lead to whole new industries, higher standards of living, increased productivity, and economic growth. Studies show that more than 2/3 of the economic growth in the U.S. since 1929 -- the greatest period of growth in the history of the world -- was attributable to U.S. technological innovation.

R&D-intensive, high-tech companies, as defined by the Department of Commerce, now employ 33% of all U.S. manufacturing workers at higher than average wages; they recently accounted for approximately 30% of all U.S. merchandise exports; and 49% of all manufacturing exports.

From modern vaccines and antibiotics to mini computers, from super conductivity to fusion energy, it should be apparent to everyone that R&D has been and is the key to our past and, more importantly, to our future quality of life and economic prosperity. Its certainly clear to our major competitors.

OECD data showed that 85% of worldwide research is done by just 5 countries -- France, Germany, Japan the UK and the U.S. Over the last 2 decades, the U.S. portion of this R&D has steadily declined. As a percent of GNP, each of these countries does more non-defense R&D than the U.S. Germany and Japan, in fact, do fully 1/3 more.

These countries promote R&D in both direct and indirect ways. Over 25% of all tax benefits in Japan, for example, are allocated to R&D. The Japanese efforts are coordinated through MITI, which targets special industries and special technologies -- from recombinant DNA in bio-technology to three-dimensional integrated circuits in information processing.

Efforts like these have permitted the Japanese, in the past, to take over the manufacturing and marketing of entire technologies -- for example, precision machine tools and consumer electronics. The European Community is also active, sponsoring, for example, a multi million dollar coordinated European effort in the computer design/computer aid manufacturing area.

Response to the Critics

In spite of the aggressive posture of our competitors, there still are critics of 861-8. I'd like to respond to their criticism head on this morning.

First, a few critics describe 861-8 as a tax break. It isn't. American R&D performers are asking to be made whole and equally important, they are asking to be treated the same way their foreign counterparts are treated by their governments. 861-8 is a penalty tax levied only on companies willing to undertake their R&D in the United States. That can hardly be considered a tax break.

Second, the critics argue that R&D done in the U.S. benefits one's worldwide business, so a portion of that R&D should be used to reduce foreign income instead of being claimed in full against U.S. income. This isn't good tax theory. Any benefit derived by one's foreign operations from U.S. R&D must be paid for in full by those foreign operations. In fact, since the 1986 Tax Act, the compensation to the U.S. must be at a "super royalty" rate.

Third, the critics argue that the deduction loss to the U.S. as a result of this policy can be recovered abroad. This is nonsense. One can almost hear the foreign tax inspector: "Let me get this straight. You rent lab space in the U.S.; you buy test tubes, white mice, and technical equipment in the U.S.; your payroll consists of U.S. scientists, engineers, and technicians; these employees ate lunch at the local restaurant; they cash their checks at the local bank; they buy their kids toys at the local store; they pay U.S. local, state and federal taxes on their wages and property -- and you want a deduction here?" The answer would be a firm no.

The inspector would note, however, that you should be allowed a full R&D deduction if only you conducted this R&D in his country. "If your country treats you as if you are doing it here anyway" he would say, "Why not?" In fact, he would offer not only the deduction, but with other agents of his government, grants, credits, rent abatement, and other incentives intended to lure your R&D from the U.S.

Finally, the critics try to turn the whole public policy argument on its head -- they argue that a resolution of 861-8 problem will lead to the loss of American jobs! How can this be?! The elimination of an extra tax on the performance of R&D in America will do exactly what common sense tells you it will do -- keep American R&D competitive!

An American CEO recently told me that one European government virtually extorted his company to do R&D in his country. This country actually traded competitive pricing for R&D jobs. Why, we must ask, are such countries doing "hand stands" to get R&D to their borders while we spend 12 years debating a tax policy to send our R&D jobs off shore?

Mr. Chairman, in a world in which no other nation on earth is even considering such a system, this 861-8 policy is wrong and anti- competitive. Regrettably, the onerous regulations are in effect as we speak today. We urge you to permanently resolve this situation.

The Basic Research Credit

Mr. Chairman, as a former corporate researcher, tax policies that effect corporate R&D mean a great deal to me. But now, wearing my more recent hat, the one of a university president, I am equally concerned about public policies that bring companies and universities together. These "linkages" are very important.

At RPI, approximately 50% of our research is collaborative research with corporations. The involvement of corporate partners is very beneficial to the universities, but I venture to say that we make an equally significant contribution to our corporate partners. There are so many benefits to these relationships. We in the universities get to work on state-of the-art problems and equipment, enabling us to attract a higher caliber of students and faculty, leading us to better prepare our young people for the type of problems they are likely to face when they enter the work force.

With all these benefits you might ask why more U.S. companies and universities are not collaborating. Based on my first-hand experience in corporate America, I can tell you there are many biases towards conducting research in-house. Today, over all, 6% to 8% of university research is conducted with a corporate partner. We believe that percentage should be doubled. But it will take public policy tools to overcome existing biases.

The doubling of corporate/university partnerships is surely a public policy goal toward which we should aspire. Making the basic research credit permanent is the first step. The basic research credit has only been in existence for 2 years, so we don't have much experience with it, but we believe we can leverage it as a policy tool if universities and companies know they can rely on it.

The R&D Credit

This morning, I would also like to emphasize the importance of the research and development tax credit and the role it plays in the overall R&D landscape.

The R&D credit currently allows a company to claim a 20 percent credit for each dollar increase in R&D over the company's average spending on eligible R&D for the previous three years. Studies conducted by Dr. Martin Baily and Rob Lawrence of the Brookings Institute have shown that this credit produced a substantial increase in industry R&D. Baily and Lawrence estimate that it lead to a increase in R&D spending of 7% more than was expected without the credit. This translates into roughly 4 billion dollars of additional research and development spending each year.

The reduction of the statutory rate of the credit from 25 percent to 20 percent in 1986, combined with the overall reduction of corporate income tax rates and the partial deduction disallowance has meant that the current credit provides less than a four percent incentive for additional R&D spending. Although a four percent incentive is better than no incentive at all, CORETECH supports certain positive changes, included in H.R. 1416, to the current credit which will, in effect, give America more for her money.

First, H.R. 1416 revises the credit's base period structure to increase the incentive given to companies who are considering investing that extra dollar in R&D. The new structure would give taxpayers, whose R&D spending equaled its fixed historical base period indexed by GNP, a full 20 percent incentive to make additional expenditures. In addition, the bill provides a seven percent credit on a reduced fixed base for taxpayers with R&D increasing less rapidly than GNP.

CORETECH commissioned Baily and Lawrence to conduct another study on this new proposed credit and found that it would provide more than 3 to 5 times as large an incentive for greater R&D spending than the current credit structure. In terms of effectiveness per dollar of revenue loss, the proposed credit is better by a factor of 4 to 1!

Second, because most R&D projects span several years, H.R. 1416 makes the R&D credit permanent so that companies can count on the credit benefits. The current tax credit fails to address the risks associated with the long-term commitment needed to bring R&D projects from the research labs to the economic market. In order for the credit to have its full incentive effect, corporate decision makers must have some assurance that they can count on the credit for all the years involved in the considered R&D venture. As a result, CORETECH supports making the credit a permanent part of America's R&D competitiveness strategy.

Finally, H.R. 1416 extends the credit's incentive effect to the maximum number of companies possible. Start-up ventures are not eligible for the current R&D credit. The proposed new credit rectifies this situation. Moreover, H.R. 1416 actually expands the number of companies eligible for the credit by roughly 10 percent.

Conclusion

Mr. Chairman, if I have impressed upon the committee a need for a predictable and stable R&D tax policy, I have accomplished my mission. A permanent solution to 861-8, a permanent basic research credit, and a permanent R&D tax credit must all be part of this stable policy landscape.

I commend Congressmen Anthony and Frenzel for their leadership on 861-8.

In addition, I commend Congressmen Jenkins, Frenzel, Pickle, Matsui, Downey and Andrews and many others on your committee, who are serving as initial cosponsors of H.R. 1416, for their work to make the R&D credit and basic research permanent.

And I thank you, Mr. Chairman, for the opportunity to testify here this morning.

Thank you.

Mr. Jacobs. Thank you, doctor.

Mr. McCloskey, please go ahead.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. McCloskey. Thank you, Mr. Chairman.

I would like to associate myself with Dr. Schmitt's remarks. I have the pleasure of serving with him on the Coretech board, and I look forward to working with him on 861 and the research and development tax credit in this Congress.

EIA is one of the oldest and largest trade associations in the country. We represent 85 percent of the U.S. electronics industry's $244 billion in annual sales and we have a strong interest in promoting a permanent R&D and basic research tax credit.

The value of R&D and its role in overall national competitiveness has received a great deal of attention in recent months. One of the most publicly discussed issues in this regard is whether the United States will be competitive in high definition television, or HDTV as it has come to be known. It is now a symbol of our Nation's competitive challenges and legislative proposals to promote U.S. participation in HDTV have been introduced by several Members of Congress.

Interest in HDTV is not simply because of the anticipated production, employment, and trade effects associated with the technology but because of the anticipated technological spillover effects on U.S. competitiveness in general.

Our view is that competitiveness is primarily an economy-wide issue, most effectively addressed by aggregate policies designed to promote such things as enhanced research and development. EIA believes that without such aggregate policies, industry-specific policies aimed at HDTV—or any other individual industrial activity deemed to be of strategic significance—will fail to improve the Nation's long-term competitive posture. We believe this is nowhere more the case than with the R&D and basic research tax credits.

Indeed, Mr. Chairman, we note that while R&D spending by U.S. firms has improved from the low levels of the late seventies, the growth in R&D spending by Japanese and German firms has been even greater. The leading firms in Japan's major industries now spend as much as or more than their United States counterparts do on R&D as a percentage of sales. We believe these rapid increases by our international competitors in R&D spending clearly indicate the success other nations have had in fashioning successful national strategies—including tax policies—to advance their own technology-based industries' global competitiveness.

As you know, the R&D credit has been in existence since 1981. While the R&D credit remains a positive inducement for companies to conduct R&D, there can be no doubt that a large portion of this benefit has been diminished in recent years. Whether through the deduction disallowance or the downward adjustment of the credit from 25 to 20 percent, we have seen a serious erosion in the incentive originally enacted nearly a decade ago.

Therefore, we believe that the credit's incentive can and should be improved and reinvigorated in three ways. First, the base period structure makes the incentive to spend an additional dollar on R&D less than the 20-percent statutory rate. In other words, R&D expenditures made in the current year increase the following 3-years' base period amounts. Any credit earned in year one is essentially paid back in years 2 through 4. Thus the credit's only incentive value is that which is associated with the time value of money.

In addition, the current structure could even create an incentive to cut R&D spending in certain years in order to increase future credits. It is our view that the bill, H.R. 1416, introduced by Mr. Jenkins, and which is currently being cosponsored by 25 of your Ways and Means colleagues, will solve these base period problems by adopting a base period structure that utilizes a historical 5-year R&D base period which is indexed by a factor not directly related to any specific taxpayer's R&D spending, in this case nominal GNP.

In addition, the bill provides a 7-percent credit on a reduced fixed base for taxpayers with R&D increasing less rapidly than nominal GNP growth. These changes alone will ensure that companies performing 80 percent of the R&D will be eligible for at least some credit incentive.

The second improvement we believe H.R. 1416 provides is that it makes the R&D credit permanent. Because most R&D projects span several years, the current credit cannot play an important role in long-term R&D decision making. Without such an assurance of long-term stability, the credit plays less of a role in the ultimate decision to spend the extra dollar on R&D than it would otherwise.

The final improvement we believe that can made to the R&D credit involves expanding the credits reached to more companies performing R&D. Specifically, H.R. 1416 would make startup ventures eligible for the R&D credit. By expanding the credit incentive to this key sector of innovation, we help support the types of firms that have historically yielded some of our Nation's greatest discoveries.

Of equal importance, H.R. 1416 recognizes that even when new startup companies do experience market sales, and become eligible for the credit, their R&D spending is frequently cyclical so that they often cannot take full advantage of the credit. H.R. 1416 enables these companies to obtain credit benefits when they are in the midst of one of their R&D valleys, precisely the time they need it most.

I would like to take a second to talk about the basic research credit.

Mr. JACOBS. Sir, I am sorry, but you do not have a second.

Mr. MCCLOSKEY. OK.

Mr. JACOBS. Your 5 minutes have expired.

Mr. MCCLOSKEY. Thank you.

[The statement of Mr. McCloskey follows:]

Statement Of
Peter F. McCloskey

President
ELECTRONIC INDUSTRIES ASSOCIATION

Thank you, Mr. Chairman. I appreciate the opportunity to present the views of the Electronic Industries Association on the R&D and Basic Research Tax Credits.

Before beginning my remarks, I would like to associate myself -- and EIA -- with the remarks of my friend and colleague, Roland Schmitt, on the section 861-8 issue. I have the pleasure of serving on the CORETECH Board with Dr. Schmitt and we have worked together in prior Congresses in advancing the cause of both a permanent R&D tax credit as well as a permanent solution to the 861 problem. I know we both look forward to continuing our work with your committee in this Congress in addressing these two critical issues.

The Electronic Industries Association is the oldest and largest trade organization representing manufacturers of electronic products for defense, telecommunications, component and consumer-end uses. EIA member companies produce approximately 85% of the U.S. electronics industry's $244 billion in annual sales. As such, we have a strong interest in promoting a permanent R&D and Basic Research Tax Credit.

We believe that corporate and basic research are essential to our economy and to our efforts to stay internationally competitive. Accordingly, it is our view that tax incentives must continue to be a central part of our national R&D public policy agenda. EIA has targeted both the R&D and Basic Research Credits as well as the Section 861 issue as top legislative priorities for the 101st Congress. However, before describing our specific goals in detail, I would like to spend a few moments on the critical role R&D plays in keeping American companies competitive.

I. THE ROLE OF R&D IN OUR INTERNATIONAL ECONOMY

Technology is critically important to America's competitiveness. It has been a major source of our export strength and has been a driving force behind our high standard of living.

In recent years, however, there have been a number of signs that both America's technological superiority and overall competitiveness are under siege. Among the most meaningful are a number of indicators that we believe are affected, in whole or in part, by overall levels of basic and applied research. These include the pace of technological innovation and diffusion, the rate of investment and the overall productivity growth rate.

By way of example, Mr. Chairman, we note that while R&D spending by U.S. firms has improved from the low levels of the late 1970's (largely, in part because of the R&D credit's impact), the growth in R&D spending by Japanese and German firms has been even faster. Indeed, the leading firms in Japan's major industries now spend as much as or more than their U.S. counterparts do on R&D as a percentage of sales. We believe, Mr. Chairman, these changes clearly indicate the success other nations have had in fashioning successful national strategies -- including tax policies -- which advance their own technology-based industries' global competitiveness.

EIA believes that U. S. industry should be given the chance to compete on a level playing field. R&D conducted by industry or funded by industry and conducted at American universities and other non-profit research organizations is critical to America's competitiveness and should be encouraged through better incentives. As the race to develop and commercialize new technologies intensifies, America must pay even greater attention than it has in the past to scientific and technological advancement. Strengthening our R&D tax incentives and removing or reducing any R&D disincentives are powerful tools to promote America's scientific advancement and economic competitiveness.

II. THE ALLOCATION REGULATION AS AN R&D DISINCENTIVE

U.S. electronics companies are some of America's largest and most successful exporters. As a result, domestic R&D incentives remain important to our industry. The section 861 regulations, which require U.S. manufacturers to allocate to foreign source income a portion of the R&D expenses which were incurred in the U.S., is an obvious disincentive to domestic R&D. In fact, because foreign nations only permit companies an R&D deduction when R&D is conducted within their own borders, the 861 regulations create an incentive for U.S. companies to move their R&D operations abroad.

Sending R&D abroad will certainly cost U.S. jobs. Moreover, it can be expected to cost us future scientific knowledge as foreign scientists learn and invent the technology of tomorrow's products. In turn, this loss of domestic know-how can only be expected to further impair our ability to compete in the next century. Clearly, Congress should act to prevent this from occurring.

III. THE NEED TO MAKE CURRENT R&D INCENTIVES STRONGER AND PERMANENT

We must do more than simply removing the R&D disincentives that exist. We must also establish effective R&D incentives. The R&D Tax Credit and the Basic Research Tax Credit form the foundation of America's effort to provide private R&D incentives. Both of these credits work to correct the underinvestment that occurs if the market is left to its own devices. EIA supports strengthening and making permanent both of these credits.

A. A Stronger, Permanent R&D Credit

Left to its own devices, the marketplace would underinvest in R&D. The R&D credit was originally enacted in 1981 to counteract this market effect and to provide an incentive for taxpayers to spend more money on R&D than they would otherwise.

The R&D credit gives taxpayers a 20 percent credit for each dollar increase in R&D over their average spending on eligible R&D for the previous three years. Since the credit was enacted in 1981, expenditures by the electronics industry on research have gone up dramatically, both in absolute dollars and as a percentage of total sales. While there is obviously a limit as to how high the percentage of R&D spending can go relative to total sales, many of our companies are still increasing their research expenditures. For companies that are growing, the R&D tax credit remains an effective marginal tax incentive.

Nevertheless, the credit can be improved. Specifically, the incentive effect of the credit can be increase three ways. First, the existing base period structure makes the incentive to spend an additional dollar on R&D less than the 20 percent statutory rate. Second, because most R&D projects span several years, a non-permanent R&D credit cannot play an important role in long-term R&D decision making. Finally, certain features of the credit make its incentive inapplicable to certain companies.

1. BASE PERIOD STRUCTURE. One of the main problems with the current credit is the structure of its base period. Specifically, under the current credit, R&D expenditures made in the current year increase the following three years' base period amounts. Any credit earned in year one is essentially "paid back" in years two through four. Thus, the credit's only incentive value is that which is associated with the time value of money. Moreover, the current structure can even create an incentive to cut R&D spending to reduce the base in order to increase future credits.

Legislation (H. R. 1416) recently introduced by Representative Ed Jenkins (D-GA) and cosponsored by 25 other Ways & Means Committee members would solve these base period problems by adopting a base period structure that utilizes a historical five year R&D base which is indexed by a factor -- nominal GNP -- not directly related to any specific taxpayer's R&D spending. In addition, the bill provides a seven percent credit on a reduced fixed base for taxpayers with R&D increasing less rapidly than nominal GNP growth. These changes alone will ensure that companies performing 80 percent of the R&D (as compared with only 70 percent under current law) will be eligible for some credit.

The new credit is clearly an excellent policy, even under the most conservative assumptions about how businesses respond to tax incentives. It represents tax policy that will help keep American industry competitive with foreign companies. EIA strongly supports the new credit base period structure proposed in H. R. 1416.

2. PERMANENT CREDIT. R&D is a long-term commitment for companies in the electronics industry. The current tax credit has never been a permanent planning device which business people could count on in making decisions about long-term projects. Without any assurance of the future of the credit, the credit plays less of a role in the ultimate decision than it could otherwise. H. R. 1416 properly makes the credit's permanency a number one priority. EIA supports a permanent R&D credit.

3. THE BASE OF COMPANIES ELIGIBLE FOR THE CREDIT SHOULD BE BROADENED. Even with the new historical base period structure, too many companies would be ineligible to obtain credit benefits. This narrow base of eligible companies is caused by several features of the current credit which H.R. 1416 addresses and corrects.

First, start-up ventures are not eligible for the current R&D credit. Start-up companies often need the credit more than any others!. Companies in these circumstances have been contributing greatly to our nation's R&D effort. For example, start-ups invented the light-bulb, the personal computer, the phonograph and the airplane. America cannot afford to forget about these very important contributors to innovation.

Second, even when these companies do experience market sales and thus become eligible for the credit, their R&D spending is often cyclical. As a result, these firms cannot take full advantage of their tax credits. The reduced base alternative credit feature of H.R. 1416 will enable these companies to obtain credit benefits when they are in the midst of one of their R&D valleys -- precisely the time they need it most!

Finally, the deduction disallowance under current law causes problems for taxpayers either subject to the alternative minimum tax or having no current tax liability. Specifically, it does not permit these taxpayers to defer the deduction disallowance until they have a regular tax liability against which to take their R&D credits. Instead, the provision merely permits taxpayers to elect out of claiming their R&D credit.

Because this approach forces taxpayers to lose R&D credits forever in order to avoid the immediate impact of the deduction disallowance, this approach obviously reduces the number of companies that will benefit by the R&D credit and as a consequence will reduce its incentive value. H.R. 1416 solves this incentive problem by permitting taxpayers to elect to reduce their credit amount by one-half of the top corporate tax rate (17 percent) instead of reducing their research deduction by the required amount.

B. A permanent Basic Research Credit.

The Basic Research Tax Credit adopted in the Tax Reform Act of 1986 gives companies a 20 percent credit for sponsoring basic research at American universities and non-profit research institutions beyond a threshold amount. This credit was adopted to stimulate vital basic research activity as well as to foster greater contact and cooperation between the corporate and university research communities. Moreover, by performing research for industry, universities are able to attract and train the best and the brightest scientists for basic research so vital to our nation's economy.

Unfortunately, the basic research credit, which was originally enacted to last for only two years and was extended for an additional year, is scheduled to expire at the end of this year. Without a permanent incentive, the basic research credit's effectiveness to forge what needs to be long-term ties is obviously reduced. Basic research, by its very nature, spans several years and thus requires multi-year commitments to bring projects to fruition. Corporate decision makers cannot make the long-term commitment to fund basic research projects without any assurance about the existence of a basic research credit in the future.

The basic research credit encourages U. S. companies to commercialize technology developed through research at our universities and other non-profit scientific research organizations. The relationship fostered by this collaboration results not only in the development of commercially viable technologies but also in the most sophisticated training of our nation's most valuable resource -- our young people. With a permanent basic research credit in place, the incentive value of the credit will only increase. Accordingly, EIA strongly supports making the basic research credit a permanent feature of America's R&D competitiveness strategy.

IV. CONCLUSION

America's ability to stay internationally competitive through the 1990's will depend upon our ability to remain at the cutting-edge of technological innovation. Research and development is an essential ingredient to this innovation. During the last decade, American industry has relied heavily on the R&D and Basic Research credits as well as the moratoriums on the Section 861-8 R&D regulations in our fight to stay competitive. These tax policy initiatives must be strengthened to give the nation's electronics manufacturers an increasing edge in world markets. We cannot afford to sit back and let our competitors capture the new product markets of tomorrow.

We must ensure that current and future R&D incentives are not eroded by the disincentive effect of Section 861-8. Furthermore, we must enact a permanent (and improved) R&D tax credit as evidence of America's commitment to constant innovation. Lastly, we must continue to encourage basic research cooperation between industry and universities and non-profit research organizations.

EIA joins its member companies in thanking Congressman Jenkins for his strong leadership on this critical issue. By working to support his efforts on our behalf, we believe we can help advance the nation's economic competitiveness into the 21st century.

Thank you.

Mr. Jacobs. Mr. Overton.

STATEMENT OF RICHARD A. OVERTON, MEMBER, TAX POLICY COMMITTEE, CHEMICAL MANUFACTURERS ASSOCIATION, AND VICE PRESIDENT, TAXES, MONSANTO CO., ST. LOUIS, MO

Mr. Overton. My name is Dick Overton, and I am vice president, taxes for Monsanto Co. I am here today on behalf of the Chemical Manufacturers Association to express the chemical industry's views on the administration's proposals concerning the R&D credit and the allocation and apportionment of research expenses under 861 of the code.

The Chemical Manufacturers Association is a nonprofit trade association representing more than 90 percent of U.S. chemical production.

First, let me give you some background on competitive pressures facing the chemical industry. In today's competitive global environment, it is simply not enough to be the low-cost producer. To be successful, U.S. companies must bring products to the market that offer superior value to the customer. American manufacturing cannot nor should not necessarily compete on labor costs. Moreover, the U.S. cost of capital is generally regarded as higher than our foreign competitors, so again U.S. based manufacturers are at a disadvantage.

This leaves research and development as one of the few areas where U.S. manufacturers can effectively compete. Research and development is important to the chemical industry as it, one, leads to increased productivity which can overcome labor and cost of capital disadvantages, and second, results in the discovery of new patent-protected products.

Because of these competitive forces, the U.S. chemical industry has deemphasized the production of basic chemicals and favors specialty chemicals. To develop a steady stream of these high-value products, a company must have the resources to spend substantial funds on research and development. In the case of Monsanto, R&D expenditures, currently $650 million, have doubled in the last 6 years. The chemical industry as a whole in 1988 spent approximately $11 billion on R&D. And over the last 10 years, the chemical industry's R&D expenditures have grown at a 13-percent annual rate.

The chemical industry is one of the few bright spots in the U.S. balance of trade picture, with favorable 1988 net exports of some $12 billion. To maintain this positive U.S. trade balance and the American jobs it represents, the U.S. chemical industry must continue the trend toward higher value products. The development of proprietary chemicals requires extensive and sustained research.

The chemical industry believes that the R&D credit has contributed significantly to its health and prosperity. Thus it should come as no surprise that CMA strongly supports the enactment of a permanent R&D credit.

CMA believes that any R&D credit should be first and foremost permanent. Research programs have to be planned years in advance and the uncertainty as to tax law can only have a detrimental effect. Secondly, the R&D credit should provide enough incentive to encourage risky R&D projects. I would note that the current legislative proposals, H.R. 1416 and Senate bill 750, are a step in the right direction because both bills eliminate the rolling base period.

I would now like to turn to the allocation of United States R&D to foreign source income under 861–8 of the Treasury Regulations.

The 861–8 provisions work in direct opposition to the R&D credit. The real economic effect of 861–8 is to disallow any U.S. tax deduction for research and development once a company is in a foreign tax credit limitation problem. I would note as a result of the 1986 Tax Act, it is estimated that about 70 percent of all companies will now have a foreign tax credit limitation problem.

Thus, on the one hand, the R&D credit creates an incentive for research by lowering its cost, while on the other hand, 861–8 operates to raise the cost by denying a U.S. tax deduction. This is a long-standing problem that needs a permanent solution.

While the administration's proposal is less than CMA would like, on balance the 6733 allocation on a permanent basis is something our members can support.

In addition, I would note that 861–8 is also used to compute the export incentive under the foreign sales corporation or FSC provisions. In this situation, R&D—by allocating R&D to export income, it has the effect of reducing the export incentive. The FSC provisions were enacted to reduce the trade deficit by encouraging U.S. exporters. Consequently, CMA believes that a permanent 861–8 solution should also be applied to FSC.

In closing, other nations offer strong incentives for research and development. To the extent that the cost of research increases as a result of unfavorable tax policy, the effect will be to curtail research in the United States as cost pressures will undoubtedly force research to more favorable countries.

The U.S.-based chemical companies must be on a competitive basis world wide. Failure to maintain our competitive position would not only imperil our export position, but also our domestic position vis-a-vis imports of foreign produced chemicals.

The chemical industry has an international technological advantage. We plan to keep it. We think technology is a source of continued economic prosperity and future jobs. A solid commitment on the part of the U.S. Government to R&D is a key to retaining and strengthening this lead.

Thank you.

[The statement of Mr. Overton follows:]

CHEMICAL MANUFACTURERS ASSOCIATION
STATEMENT ON RESEARCH AND DEVELOPMENT TAX PROVISIONS IN PRESIDENT BUSH'S BUDGET FOR FISCAL 1990

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose member companies represent more than 90 percent of the productive capacity of basic industrial chemicals within this country. We welcome this opportunity to submit the views of the U.S. chemical industry on provisions in President Bush's Fiscal Year 1990 budget proposal that would affect the tax treatment of research and development expenses.

The President proposes to modify and make permanent the incremental 20-percent income tax credit for the amount of qualified research expenses. Unless extended, the credit will expire December 31, 1989. In addition, the President proposes to modify and make permanent a provision to permit taxpayers to allocate 67 percent of their expenses for research and development expenses conducted in the United States to U.S. source income. The balance of such expenses would generally be apportioned between U.S. and foreign income on the basis of either gross sales or gross income. CMA strongly supports the President's proposal.

The U.S. chemical industry has a vital interest in the continuing search for ideas that will contribute to future expansion of productive capacity and new job opportunities in the United States. In 1987, our industry spent $9.5 billion for research, rising to $10.5 billion in 1988, more than twice the amount expended in 1981. The chemical industry ranks fourth among all U.S. manufacturing in research and development spending.

Over the past several years the composition of output of the U.S. chemical industry has been shifting from the production of basic commodity chemicals toward the increased production of new specialty chemicals that have evolved from continuing research and development. Research and development is also important to the U.S. chemical industry not only because it leads to the discovery of new, patent protected products, but because it leads to increased productivity which can overcome labor and capital cost disadvantages.

Although the fundamental nature of the U.S. chemical industry is changing, it continues to provide jobs for more than 1 million U.S. workers. Moreover, the chemical industry continues to be a strong positive contributor to U.S. trade performance. As you know, our nation's merchandise trade balance in 1988 showed a $137.3 billion deficit, but exports of chemicals totalled $32.42 billion and exceeded imports by $11.43 billion. The strong export position of the U.S. chemical industry is, however, very much dependent on maintaining the productivity gains and stream of new products that derive from a large, effective private sector research effort.

On several occasions in the past eight years, CMA has appeared before this committee to support the extension and improvement of tax incentives for U.S. research and development. The reason for these incentives is fundamental: as already noted, research and development activities form the basis for new products, new markets, and increased economic productivity. Without these activities, competitiveness of both the United States and the U.S. chemical industry will decline.

For valid reasons, indusrialized nations typically offer strong incentives for research and experimentation expenditures. Nations that develop new science and technology are normally those in which the new technology will be first employed and new plants and new jobs will be created.

Let us consider the history leading to the current proposal that would modify and to make permanent the income tax credit for qualified research expenses.

The income tax credit was first adopted in 1981 as one equal to 25 percent of the excess of qualified research expenses in the current year over a moving average of such costs in the three prior taxable years. That credit expired in December, 1985, but was retroactively extended on a modified basis through 1988 in the Tax Reform Act of 1986. The 1986 legislation reduced the credit rate from 25 percent to 20 percent, tightened the definition of qualifying expenses and modified the university basic research credit. The Technical Amendments and Miscellaneous Revenues Act of 1988 extended the credit at 20 percent through December 31, 1989. The Act also reduced the deduction for qualified research expenses by 50 percent of the research and experimentation tax credit for that taxable year.

CMA strongly believes that the research and experimentation tax credit should be made permanent and has consistently expressed this position since 1981. The credit has contributed significantly to the continuation and expansion of research programs in general (cf. the 1985 study "The Need for a Permanent Tax Credit for Industrial Research and Development," by H. N. Bailey and R. Z. Lawrence of the Brookings Institution and by Data Resources Inc.), and to the health and prosperity of the United States chemical industry in particular. The chemical industry has a vital interest in the continuing search for ideas which will contribute to future expansion in new technology, processes, production, and the development of new job opportunities in this country. The industry is in the forefront of U.S. research-oriented activities.

As a nation, we need a strong private sector research establishment. New technology is a primary source of continued economic growth and the basis for future increases in productivity and living standards. It is imperative that U.S. policy encourage domestic research activity. Research programs typically require long lead times, and the uncertainty about the future that will result from a short-term extension of the research tax credit will be detrimental to new research programs.

CMA believes the President's proposal to modify the present credit and make it permanent at a 20-percent rate represents a significant start on the job that needs to be done. The proposal would modify calculation of the credit's base amount. The new base would be a fixed historical base equal to 102 percent of the average of the taxpayer's qualified research expenses for the years 1983 through 1987, indexed to growth in the gross national product. Alternatively, firms could claim a separate credit equal to 7 percent of the excess of the current year's qualified expenses over 75 percent of the base amount. Current deductions for research and development expenses would be offset by the full amount of the credit. In addition, the proposal would liberalize the trade or business test to enable new firms and firms entering new lines of business to claim the credit.

The most positive aspect of the President's proposal is that it makes a commitment that the research and experimentation tax credit should be adopted on a permanent basis rather than to provide a short-term renewal. The proposal also recognizes the need to improve the base for computing the credit, by substituting a fixed historical base period for the current moving base period. However, the proposal could significantly reduce the amount of benefit provided currently under the credit. For example, it would offset the current deduction of research and development expenses by the full amount of the credit, as opposed to only 50 percent under present law.

While these shortcomings give our industry concern, we strongly second the President's call that the research and experimentation tax credit be adopted on a permanent basis. Until that is done the real economic incentive the tax credit can provide is substantially reduced.

CMA also strongly supports the President's proposal to permit taxpayers to allocate 67 percent of their expenses for research and development conducted in the United States to U.S. source income. The President's request that this be a permanent part of the law is a positive step.

Since 1981, Congress has adopted a statutory moratorium on five occasions to prevent the allocation of research and development expenses between U.S. and foreign source income that would be required under Treasury Regulations 1.861-8. These include amendments to ERTA

(1981), DEFRA (1984), COBRA (1985), Tax Reform Act (1986), and TAMRA (1988). CMA submits that the permanent solution presented in the President's proposal is a much better way to resolve this problem.

It should be recognized that the Treasury Regulations currently work in direct opposition to the research and experimentation tax credit discussed above. Although Treasury Regulations 1.861-8 deals with the ability of companies to use the foreign tax credit to effect a portion of their U.S. income tax, the real economic effect of the regulations is to disallow any deduction for research and development expenses after a company is in an excess foreign tax credit position.

In 1983, CMA testified at length on this issue before the House Ways and Means Subcommittee on Oversight. (Hearings, Subcommittee on Oversight, House Committee on Ways and Means, 98th Congress, First Session, October 26; November 3, 1983). At that time we stated that the operation of the regulations would undermine the effectiveness of the research and experimentation tax credit and would significantly increase that cost of research in the United States. Moreover, we indicated that this increased cost of conducting research in the United States would be an important factor that would be considered in choosing whether to locate new research facilities here or abroad. We continue to believe that the regulations are ill-advised.

On five occasions, as noted above, Congress has wisely enacted and renewed the moratorium on apportionment of research and development expenses under the regulations. Unquestionably, a principal reason for doing so was the concern that the operation of the regulations was to encourage multinational businesses to shift research activities abroad. (See "Description of Proposals Relating to Research and Development Incentive Act of 1987 (S.58) and Allocation of R & D Expenses to U.S. and Foreign Income (S.716)", Joint Committee on Taxation, JCS-6-87, April 2, 1987.)

Recent data of the National Science Foundation suggest there is now widespread evidence that American corporations are increasingly conducting research outside the United States. As reported by the New York Times:

> "American companies have always done some of their R & D offshore, of course; mostly in Japan and Europe, but until three years ago, such corporate spending almost always grew more slowly than research outlays at home.
>
> Now a drastic change is showing up in the data collected by the National Science Foundation which tracks research outlays by American corporations. Recent surveys show that R & D spending abroad jumped by 33 percent in 1986 and 1987, to a total of $47 billion, while spending at home went up by only 6 percent, to $52.8 billion. The falling dollar accounted for some of the big increase, but even after adjusting for devaluation, spending rose faster abroad than at home and most likely did so again last year, experts say."
>
> New York Times,
> February 22, 1989, pg. D-2.

One reason for this trend to move research offshore is that the effects of the excess foreign tax credit limitation on research are far more widespread than previously assumed. It is estimated that, as a result of the rate reductions in the 1986 Act, almost 70 percent of all corporations will have an excess foreign tax credit limitations problem. As recognized by the staff of the Joint Committee on Taxation in 1987:

> "On the other hand, the rate reduction potentially modifies the conclusions reached in the Treasury study. The percentage of worldwide income of U.S. corporations earned by firms in an excess foreign tax credit position is expected to rise as a by-product of the rate reduction, with the result that any change in the R & D allocation rules can now be expected to have a more uniform effect, from firm to firm, than was true in 1983. Consequently, the rate reduction tends to make any future revision of the R & D allocation rules a relatively more efficient mechanism for influencing taxpayers' R & D decisions. This is because the mechanism works only on taxpayers with excess credits, and it works better to the extent that it causes a greater proportion of taxpayers to face similar incentives for undertaking R & D in United States."
>
> JCS-6-87, pg. 42.

CMA supports the President's proposal to allocate 67 percent of research expenses incurred in the United States to U.S. income. Although we believe a still larger portion should be allocated to U.S. income, the proposed allocation, if adopted on a permanent basis, would provide a more rational tax framework for research activities in the United States.

We should also point out that the required allocation in Treasury Regulations, 1.861-8 is also used to compute the allowable export incentive under the Foreign Sales Corporation ("FSC"). The FSC provisions were enacted to enable U.S. exporters to be more competitive in world markets. When the regulations are applied in this context, allocating research and development expenses to export income has the effect of reducing FSC export incentive. CMA urges that any proposed solution on the allocation of research and development expenses should also apply to the Foreign Sales Corporation provisions.

As CMA has emphasized, continued and expanded research and development in the United States is vital to our nation's economic future. Domestic tax policies that increase the cost of research in the United States while other nations continue to offer strong incentives to conduct research in their countries, will provide continued motivation to reduce U.S. research activities activities, or to locate the research activities of U.S. firms outside the United States.

As a nation, America needs a strong private sector research establishment located in the United States. Through research we gain new technologies which are the source of continued economic growth and productivity, and provide the basis for new jobs and rising living standards.

Mr. ANTHONY. Thank you, Mr. Overton.

The next witness is Mr. McNeill.

STATEMENT OF ROBERT L. McNEILL, PH.D., EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. McNEILL. Yes, thank you, Mr. Chairman.

I am pleased to be here on behalf of the Emergency Committee for American Trade, which is an organization of the heads of 57 large U.S. corporations with very extensive international business operations. The 57 members of ECAT had 1988 worldwide sales of $914 billion and they employ about 5 million workers.

I am here to talk about the section 861 allocations concerning research and development expenditures. For the companies that I represent, this is a matter of very vital economic interest.

Under the current regulations, Mr. Chairman, our members are severely penalized because the tax costs of doing research and development in the United States have been very substantially raised.

Under the current regulations, as you well know, if you do half of your business in the United States and half abroad, the regulations require that you allocate to your foreign income one half of the R&D expenditures that you incur in the United States. So that if you took a company with a 50/50 division of business between the United States and abroad and a $200-million research and development budget in the United States, the regulations force $100 million of that R&D expense abroad as a cost to the foreign subsidiaries, a cost that is not recognized by foreign governments. The resultant effect is to raise the research and development expenditure by a U.S. tax cost of $34 million for that particular company in that particular year.

With this kind of a cost penalty, a lot of American companies are reviewing their domestic research and development activities and in some instances are looking abroad. It is interesting to note in a recent report of the National Science Foundation, that foreign civilian research and development expenditures are very close to those of the United States, and are increasing at very, very rapid rates.

Our concern is that without a solution of the section 861 R&D allocation issue, that the United States will tend to lose domestic R&D activities with resultant losses of innovation technology. This can only work to the disadvantage of our economy and the employees of our member companies.

We do hope that a solution can be reached. And we are very grateful to you, Mr. Chairman, for your efforts over the years in seeking such a solution. We are terribly supportive of what you are doing, and wish you every success. I thank you very much.

[The information of Mr. McNeill follows:]

TESTIMONY
OF
EMERGENCY COMMITTEE FOR AMERICAN TRADE

I am delighted to be here today on behalf of the Emergency mmittee for American Trade, or "ECAT", an organization of out 60 of the largest U.S. multinational corporations. These rporations employ nearly 5 million people worldwide and had mbined worldwide sales in excess of $900 billion last year. ey compete in virtually every market in the world. As an ganization, ECAT focuses exclusively on international tax and ternational trade issues.

I am here today to discuss the 861 regulations as they ply to research and development. These regulations treat a rtion of U.S. R&D "as if" it were done abroad. Although ese regulations work through the foreign tax credit, their actical effect is to deny a deduction for a portion of one's S. R&D. In effect, the regulations impose a penalty on the nduct of R&D in America.

The policy inherent in the regulations could not, in our dgment, be more wrong. We should be doing everything ssible to encourage R&D to stay in America -- not vice rsa. Our research, our innovation, and our technology are e keys to economic growth and our quality of life. New oducts, new manufacturing processes -- in fact, whole new dustries -- result from our R&D. Diseases are conquered, rm yields are multiplied, energy self-sufficiency is hanced, and manufacturing productivity is increased, all as a sult of R&D.

It is difficult to understand why anyone would encourage S. R&D to be done abroad, by treating it "as if" it were done ere anyway. Apparently, some believe that, because U.S. R&D n benefit both U.S. and foreign operations, the foreign erations should pay for their share of that R&D and claim the duction for their share in their country of operation. ctions of our tax laws other than 861, however, already quire foreign operations to pay for the use of U.S. R&D. In ct, since the Tax Reform Act, they must pay at a "super" te. Charging again under 861 is a true "double count."

Also, the claim that foreign countries will grant a duction for R&D done in the U.S. cannot be supported. rmany, for example, is not going to grant a deduction for search done in Illinois by ECAT members such as Caterpillar John Deere. Japan will not grant a deduction for research ojects undertaken by professors at the University of linois. Does anyone really think these countries will be nvinced that such deductions are appropriate merely because S. tax regulations "deem" the R&D to be done there?

I would also like to address two issues raised by those posed to a resolution of the 861 problem, because these sues particularly implicate my members. The first issue volves the claim, offered as a criticism, that the benefits a resolution of the 861-R&D problem would go primarily to proximately 25 multinational corporations. While the study which this claim is based is outdated and the precise number companies affected is not known, the premise of the claim is rrect. Obviously, the Treasury cannot deem some of your R&D have been done by your foreign operations unless you have reign operations. And since the practical effect of 861 is impose a penalty on R&D, those who do the most R&D will be nalized the most, and will benefit the most if this penalty removed.

Every summer Business Week publishes a list of the American companies with the largest R&D budgets. GM and IBM have been one and two, or vice versa, for many years. Both are ECAT members. Looking through the rest of the list, I see such ECAT members as DuPont, Kodak, Hewlett-Packard, Dow, 3M, Johnson & Johnson, Merck and many others. In other words, ECAT members perform a substantial portion--if not the majority--of civilian research done in this country. These are the companies most affected by 861, and the ones who would most benefit by its revision. It should be obvious that a regulation aimed at R&D-intensive companies which compete in the global economy will most affect those companies carrying the largest R&D burden and most effectively carrying the American banner into international markets. I do not believe this fact is damning.

The second criticism is one I have heard only recently. It charges that if we do not continue to treat U.S. R&D as if it were done abroad, we will lose American jobs and investment. Frankly, this seems illogical on its face. Nevertheless, the argument as I understand it is that many countries -- for example, Germany -- have higher taxes than the U.S. If this high tax situation is exacerbated by 861 allocations, it will serve as a barrier to entry. This barrier will keep American jobs and investment at home.

This convoluted argument is fundamentally wrong. Barriers to entry are not good things. This is not "Fortress America," and we do not want to return to Smoot-Hawley days. We want ECAT members and other companies to compete in Germany, because it is one of the largest markets in the world. And I am not just speculating on the benefits of American participation in foreign markets. Recent Department of Commerce data show that R&D-intensive, high tech multinationals like many of those in ECAT provide one third of all U.S. manufacturing jobs and almost half of all U.S. manufacturing exports. In addition, ECAT will soon publish a major study that will show that multinationals contribute significantly more to the U.S. economy than those companies which try to do it all from home.

Let me end with a plea for a resolution to the 861 problem. R&D planning at ECAT companies is a long-range thing. You have addressed 861 on a temporary basis in 1981, 1984, 1985, 1986, and 1988. The legislative history associated with your actions show you do not like these regulations either. In 1986 you even directed the Treasury to revise them, and in 1987 you enacted the so-called 67% compromise as a permanent solution. But Black Monday intervened, and so we are still seeking stability and permanence in this area. Although I know there are many pressing items on your agenda, those of us interested in this area have been very patient. More important, we have made our case repeatedly, and our case is obvious. Our tax laws should not penalize U.S. R&D nor encourage its export. I hope you agree, and I thank you for inviting me here today.

April 12, 1989 Robert L. McNeill

Mr. **Anthony** [presiding]. Thank you, Mr. McNeill.

Mr. Overton, I guess what puzzles me is why we cannot get a permanent solution to a problem that all parties agree should be made permanent. This has been going on since 1977. Congress has blocked the Internal Revenue Service on a multitude of occasions.

Both President Reagan, President Bush, the House Ways and Means Committee, the full House, the Senate Finance Committee, the full Senate, have all agreed the last 3 years that there should be a permanent solution. I am just wondering if you have any insight as to why we cannot resolve this issue.

Mr. **Overton**. I would be looking for you for a little guidance on that.

Mr. **Anthony**. I have about run out of ideas.

Mr. **Overton**. You know, maybe one point I would also maybe like to note that, at least in the past, one of the arguments used against the R&D moratorium has been that some way it is unfair to allow a U.S. tax deduction in the States, and then have the technology transferred overseas and the income some way escape taxation.

Toward that point, I would simply note that some of the recent legislative changes now prohibit that. In the sense that—remember we changed 367D, I think, in the 1984 tax bill, and then more recently the 482 royalty issue commensurate with income.

So essentially now, none of that technology can really leave the shores without being taxed. So to me, that also should knock out one of the remaining arguments against it.

Mr. **Anthony**. I apologize to Mr. Schmitt and Mr. McCloskey. I got here, after you testified, if either one of you testified or have a particular knowledge on the 861 issue, feel free to seek recognition, because it is something that I have poured a lot of effort into the last 3 years to try to find a permanent solution, and then each year there is always some new crisis that appears that forces it out during the conference.

Yet, the very next year when the budgetary process begins, there it looms right back again, with a request that it be made permanent.

I must tell you that I have gotten a little bit exasperated at working on it for 3 straight years with literally everybody saying that it should be made permanent, yet nobody will just sit down and make it permanent and get it behind us. So I am trying to find a way that maybe we can appeal to a broader base of people that maybe would understand this.

Let me just try each of the members of the panel to see if you have a comment on this.

One thing the revenue people always say, "It cost a lot of money," and my response has always been, "Yes, it may cost a lot of money, but it is going to cost you a lot more money in the long run if you do not solve it."

Do you see it as a jobs issue? In other words, will the companies eventually take their research and development off-shore? Will we lose the capacity with our scientists domestically, and we will lose those high paying jobs? Is that a real issue?

Mr. McNeill.

Mr. McNeill. Yes; it is an issue. I have a company that has research and development laboratories that are many decades old and that require replacement at a very considerable expense. That company is looking, among other things, at the section 861 R&D allocation requirement, and asking itself the question whether it would not be more economic for the corporation to replace what are now domestic R&D laboratories with laboratories in Canada or elsewhere, where tax and other incentives are offered to attract such R&D investments.

Mr. Anthony. Would your company be treated better in Canada under research and development than the United States tax laws treat you?

Mr. McNeill. Yes, sir, both from a tax perspective and from a general economic perspective. I believe the risk to the U.S. economy is that if this, other companies do switch R&D activities abroad, then I think jobs would follow to the place where the research and development took place.

So I think that from a jobs perspective the observation is that if you continue to penalize the doing of research and development here, that you are going to create jobs abroad rather than in the United States.

Some of my pharmaceutical members, for example, have developed new medicines and new pharmaceuticals in their foreign laboratories so that the attendant initial job benefits are not here in the United States.

I think that section 861 is very much a jobs issue, and I think the jobs issue cuts very much against the interests of the United States under the present regulations.

Mr. Anthony. Well, if it can be clearly demonstrated that it is a jobs issue, and in fact, if the United States Tax Code discourages you to build new laboratories in the United States, and Canada is encouraging you to come there, it would appear to me that, collectively as a Government, we ought to solve that problem.

You say it is clear. I, again, did not hear the testimony of Mr. McIntyre for Citizens for Tax Justice, but I have read his material before, and I know that he is not a supporter of 861. Can he make a logical argument that it is not a jobs issue or that the jobs would not leave?

Mr. McNeill. I was not here when he testified this morning, Congressman, so I cannot specifically refer to what he said here.

Mr. Anthony. Anybody on the panel hear him?

Mr. McCloskey. I read his testimony, and would say he offered a very convoluted argument.

I think it is clear, the problem here is that from a tax point of view, the purists want to have R&D expenditures matched directly with the revenues which may be associated with specific R&D expenditures. That would be wonderful if the rest of the countries in the world did that, but the fact is, no other country does.

So our attempt to take some portion of research and apply it against our foreign source income just will not work. Section 861 effectively denies a deduction for a portion of U.S. R&D.

It is the intersection of tax philosophy with reality and what the reality ought to be in terms of public policy to encourage research and development in the United States—that is the critical issue.

And research and development in the United States is a jobs issue, because R&D has a strong downstream impact on manufacturing and production. A dollar spent on R&D in the United States is better than almost any other investment we can make.

Mr. McNeill. Mr. Anthony, there are only, to my knowledge, three other countries in the world that require the apportionment of overhead, including R&D. Turkey is one and Sweden is another, and I have forgotten——

Mr. McCloskey. I think the Philippines was the third.

Mr. McNeill. The Philippines was perhaps the third, but other than those three countries, there is no country in the world, certainly none of our major trading partners, that has an allocation requirement such as the United States has, not only for R&D, but for general overhead expenses as in section 861.

So from a tax consequence, it is very much in the interest of corporations to minimize costs, the tax consequences in the example that I gave is a very meaningful disincentive to the conduct of R&D in the United States.

Mr. Anthony. Well, Mr. McCloskey mentioned another word that I have written down here, and that is "productivity." It would appear to me that if the Tax Code forces you to make these decisions, and in fact, you do make those decisions, whether or not the jobs follow, it appears to me that the productivity, as a result of the innovations that occur someplace else, definitely will fall to the benefit of Canada or some other country and to the detriment of the United States.

Then, I have written down a third word, and that is "competitive." It would appear to me that in the long run, we would be less competitive, and we are fighting this enormous trade imbalance to begin with, and it seems to me that this is a clear case where nobody, maybe with the exception of somebody like Mr. McIntyre, will argue that this is not a problem that is crying out for a solution.

Mr. Schmitt, I will recognize you and then——

Mr. Schmitt. Thank you, Mr. Chairman.

Mr. Anthony. We will all just have to agree to keep working on it and see if we can find a permanent solution.

Mr. Schmitt. At the end of my testimony, I was cut a little bit short, because I went over time, but I was going to wind up by commending you and Congressman Frenzel both for your leadership on this issue, which is greatly appreciated by most.

The argument of Mr. McIntyre, I find very difficult to understand. He basically states that not having 861-8 is an incentive to move manufacturing jobs offshore, and I do not comprehend that at all. I do not know much about tax law, but I was in research and development for 36 years, leading GE's corporate R&D for 9 of those years.

If I am doing research in the United States that produces a product that I cannot only sell in the United States, but I find that there is a foreign market for it, and in time as the foreign market grows, I may even put a plant over there to start serving part of it, which usually, incidentally, helps my exports as well, and the net effect of 861-8 is to increase my tax bill as I am improving the U.S. trade balance, as I am improving U.S. international competitiveness, to charge I was hurting U.S. jobs is just absolutely a backward kind of a reasoning.

Mr. McNEILL. Mr. Anthony, I hate to talk as much as I am, but I did read the article that Mr. McIntyre had written in, I believe, the New Republic magazine. As I understand his argument, it is that if you increase the United States tax cost on research and development relative to say, Germany, that you, therefore, keep R&D at home.

I think the opposite is the obvious conclusion, because if the tax cost is raised here, and there are lesser or no tax costs in Germany, I think the opposite conclusion is obvious, that is that R&D will move to Germany.

Mr. ANTHONY. Well, I will just close by making one final observation, and I will say to the four of you and anybody else that would be listening that this will probably be our most difficult hurdle to overcome, but I am becoming very concerned that if this type of attitude persists much longer in this country, we are going to be in dangerous trouble legislatively. That is, the first thing they will say is it cost *x* number of dollars over so many years, and we have this enormous budget deficit problem, and we cannot be spending any more money.

You are going to have to help us educate, not only other Members of Congress and the administration, but the public at large, that at some point, we are going to have to think about spending some money in this country in order to solve some of the problems, so that we can be competitive, and we cannot just ignore the fact that you can always just escape solving a problem by saying that we got this deficit problem and always put the problem off.

So I say to you, as a panel, we are going to have to find a way to overcome this mind set that has developed not only on this committee, but in the Congress as a whole, that the easiest way to make a hard decision is to say, "It cost money. Gramm-Rudman says that we have got to balance the budget, and therefore, I am sorry, but I cannot help you."

Because 10 years from now, and we look back, and we are going to say, "We were really, really sorry that we did that," and I think we are going to be shirking our legislative responsibilities.

I guess maybe what I need is a little pep talk from you, because I fought this battle for 3 years, and I have been very disappointed that we have gotten it so close only that to have different glitches show up. So we are going to have to find a very solid way to sell the package this year.

Mr. McNEILL. Mr. Chairman, please do not let discouragement diminish your interest.

Mr. ANTHONY. Well, my interest has not diminished, because I think it is something that definitely has to be resolved, and I thank each of you for your participation and for the record that you have established on the positive side of this issue, and we will just continue to work together and see if we can get the job accomplished.

A point that needs to be made over and over again, and that is the fact that your particular benefit has expired. Others that are in this package will expire in the future, but you have one that has expired, and we have got a problem on our hand as to whether or not to reimplement it or live with Treasury's interpretation.

If previous Congress' actions are any guideline, I think that Congress does not like what Treasury has proposed. So maybe we will find a solution before this year is up, but I thank you for your contribution to the record.

Our next panel is the National Committee for Adoption, William L. Pierce, president. Is Mr. Pierce present?

[Pause.]

Mr. ANTHONY. We could have some help with the new name tags.

We also have the U.S. Telephone Association, Victor S. Gomperts, chairman, tax committee, corporate director-taxes, NYNEX Corp., New York, NY.

National Aviation Associations Coalition, Jonathan Howe, member, president, National Business Aircraft Association.

Finally, we have the Travel and Tourism Government Affairs Council, William D. Toohey, vice chairman, president, Travel Industry Association of America.

[Pause.]

Mr. ANTHONY. If you would, we would recognize the witnesses in the order in which they were called to the witness table and would just ask you to please observe the 5-minute rule, and then we will have an opportunity for some questions and exchange afterwards.

Mr. Pierce, you are recognized.

STATEMENT OF WILLIAM L. PIERCE, PRESIDENT OF THE NATIONAL COMMITTEE FOR ADOPTION

Mr. PIERCE. Thank you, Mr. Chairman.

My name is Bill Pierce, and I am the president of the National Committee for Adoption. We are the headquarters organization of the nonprofit, voluntary movement to strengthen adoption and related services in this country, and we thank you for being invited to testify. We would ask that our entire statement be placed in the record, and I would like to very briefly summarize.

Mr. ANTHONY. Your entire statement will be printed in the record.

Mr. PIERCE. We want to talk about the President's budget proposal to reintroduce into the Tax Code a very modest tax deduction for adoption expenses. We really do appreciate him doing it, and it is in our view an important step up the ladder.

It would essentially reinstate a deduction which was available back in 1981. It would be effective for tax years beginning 1990 and would double the old 1981 deduction to $3,000. The existing expenditure program would apparently be left in place.

We applaud the President's move to restore the tax deduction. We believe that once the Senate has confirmed HHS Assistant Secretary for Human Services designee Mary Gall, who is an expert on adoption by virtue of her chairing the White House Task Force on Adoption, and who is coincidentally the adoptive parent of two children—that we will have a leadership in place within HHS to make these two provisions work as Congress intended them to be.

However useful as these two pieces of legislation are, and optimistic as we may be about the appointment of Mary Gall to oversee the Office of Human Development Services, where the title

IV-E Social Security Act responsibilities lie, there is still more that needs to be done.

We believe it would not be excessive for this Congress and this committee to accept President Bush's welcome initiative and improve it slightly by incorporating it into a broader adoption tax deduction bill.

Specifically, we would like to see Congress enact H.R. 1205, the legislation sponsored by Mr. Rangel, Mr. Lehman, and others, and a companion bill in the Senate, Senate bill 479, the chief sponsors of which are Senators Hatch and Simon.

This would mean that not just those parents who adopt some of the children with special needs, but all parents who adopt legally, including all children with special needs, all domestic adoptions, all international adoptions, whether it is through public welfare agencies or local voluntary agencies, whether church related or nonchurch related—all of them would receive some sort of benefit.

The Congress would be taking a substantial step toward eliminating discrimination against the children of all races and ethnic groups and physical conditions and ages who need homes, wherever they were born and whomever plans to adopt them.

Right now, that discrimination exists, and only a small fraction of those who adopt stand to receive any help.

I want to point out that any of these revenue measures, and you have just been talking about them, Mr. Chairman, and talked about spending a little money, should be examined with an eye to the very real savings to be obtained if, through a meaningful tax deduction law, the voluntary, nongovernmental segment of the adoption and maternity services system can be again allowed to function.

Deductions would allow nongovernmental agencies to provide medical services to pregnant women and their babies, and those expenses would be reflected in adoption fees instead of in Medicaid expenditures.

Deductions would allow nongovernmental agencies to provide housing and job training and educational services, and those expenses would be reflected in adoption fees, not in AFDC expenditures.

Deductions would allow nongovernmental agencies to provide social services and transportation costs and administrative services and training and the legal cost necessary to adoptions, and those expenses would be reflected in adoption fees, not in the uncontrollable administrative costs that are part of title IV-E that the entire Congress is concerned about.

The irony is that many of these same expenditures, if covered through donations to qualified charitable organizations, are now deductible.

We say, "Why not allow the deduction if the expense the Federal Government would otherwise pick up is paid for by adoption fees instead of outright contributions?"

The cost of adoption maternity services are being underwritten now, either directly when they are provided through existing Federal expenditure programs, most of which are entitlements, or through the title IV-E program, or indirectly through deductible contributions.

What we are suggesting is that by simply allowing ordinary families to pay for private services themselves through adoption fees which are deductible, you will stimulate the provision of more and better services to a broader group of children and families all at less net cost to the Federal Treasury.

Thank you.

[The statement of Mr. Pierce follows:]

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TESTIMONY OF WILLIAM L. PIERCE,
PRESIDENT, NATIONAL COMMITTEE FOR ADOPTION,
BEFORE THE COMMITTEE ON WAYS
AND MEANS,
U. S. HOUSE OF REPRESENTATIVES

APRIL 12, 1989

My name is William L. Pierce and I am the president of the National Committee For Adoption (NCFA). NCFA is the headquarters organization of a non-profit, voluntary movement to strengthen adoption and related services. NCFA was founded in 1980. We have 141 local non-profit, voluntary adoption or maternity service agencies throughout the United States in our membership.

In addition to providing technical assistance to its member agencies, NCFA works for the development of adoption-friendly policies and practices by public and private institutions. We speak on behalf of adoption and maternity services agencies as well as those families and individuals touched by adoption. Today, we speak not only from the vantage point of a national organization with dozens of adoption agency members but also from a national organization with hundreds of active individual members, most of whom are adoptive parents. From time to time we also respond to invitations to testify on important public policy questions and thank the Chairman and the Committee for inviting us to present testimony today.

In considering the President's Budget Proposal to permit an itemized deduction for certain expenses incurred in connection with the adoption of a child with so-called "special needs," I want to discuss several questions. First, what is the history of the deduction? Second, what is the situation with the current law? Third, is the President's proposal worthy of support? Fourth, what would we like to see enacted this year? And finally, what would we prefer Congress to eventually enact, apart from what has been proposed by either the Administration or any Member?

Because of the time limit, I will discuss these very briefly and would be pleased to provide additional information for the record.

First, the history of the deduction. A modest deduction providing up to $1,500 for the adoption of some children with special needs became effective in 1981. That deduction was mainly the result of pleas by adoptive parents who said: help us pay the expenses of adopting children who would otherwise cost the Federal treasury a great deal more to keep in inappropriate foster care. Over objections from certain child and public welfare theorists and Treasury, the deduction became law. The provision was not perfect. It didn't cover all special needs children, let alone all children who would have benefitted. The provision was complex to administer, at least partially because of the barriers erected by people within the Department of Health and Human Services and Treasury. The provision was obviously of more benefit to persons of higher income than to those of modest income. And the provision didn't necessarily translate into better services before, during and after adoptive placement. Nor did the provision resulting in more children getting out of foster care and into good, permanent, loving homes.

The result was that, from the start, many of us were calling for improvements in the law. Some called for expanding the deduction to all children who were legally adopted, increasing the amount of the deduction and making modest changes in the Code to encourage employers to offer adoption benefits to their employees. Others wanted to go beyond a tax deduction to a tax credit. And still others wanted to use the revenues to pay for services to a broader constellation of prospective adoptive parents, through some mechanism other than the tax deduction.

This intense interest in improving matters resulted in a difference of opinion between the Senate and the House during consideration of the Tax Reform Act of 1985. The Senate wanted to broaden the deduction; the House wanted to try the approach of an expenditure program, administered through the

Adoption Assistance Program under Title IV-E of the Social Security Act. In Conference, the Senate deferred to the House.

What was expected to be a victory for adoption advocates turned into a lengthy wait for regulations. Despite clear directives from Congress and strong nudges from outside groups like ours, regulations were late in coming and when they arrived they were, in our view, quite at variance with the clear intent of Congress. This is, of course, not the first time that regulations have not been what Congress or advocacy groups wished. Meanwhile, the past deduction had been eliminated and the new program was not functioning. In essence, the new program is still not functioning. We would ask this Committee, by way of verifying what we are claiming, to ask HHS to provide it with a listing, by fiscal year, and by state, of the Federal matching expenditures for those provisions clearly enunciated in the Dec. 7, 1985 Report on H.R. 3838. Three full calendar years have elapsed and we contend the data will show virtually nothing has been done.

This should not be surprising. One reason for the push to revise the first law was the response from the states. In almost every instance they refused to take the steps necessary to easily qualify all those adopting children with special needs for that modest deduction, despite a special ruling obtained by one of the Senate's strongest advocates for the deduction, Orrin Hatch. It was not because the states did not know about the ruling, either. Our organization contacted every state. And then-Assistant Secretary Dorcas Hardy also tried to prod the states into action.

So, in our opinion, the current law is just not functioning as Congress intended. However, it may be that HHS data will show a surprising increase in the number of children for whom "nonrecurring adoption expenses" were paid and the number of adoptive parents who therefore got some help.

The President's budget proposal represents, in our view, an important step up the ladder. It would essentially reinstate the deduction which was available in 1981, effective for tax years beginning Jan. 1, 1990, but would double the maximum deduction to $3,000. The existing expenditure program would apparently be left in place.

We applaud the President's move to restore the tax deduction. We believe that once the Senate has confirmed HHS Assistant Secretary for Human Services Designee Mary Gall, an expert on adoption by virtue of her chairing of the White House Task Force on Adoption and coincidentally the adoptive parent of two children, there will be the leadership in place within HHS to make these two provisions work as Congress intended for the benefit of waiting children and adoptive families.

Useful as these two pieces of legislation are, and optimistic as we may be about the appointment of Mary Gall to oversee the Office of Human Development Services, where the Title IV-E responsibilities lie, there is still more to be done. We believe it would not be excessive for this Congress to accept President Bush's welcome initiative and improve it slightly by incorporating it into a broader adoption tax deduction bill. Specifically, we would like to see Congress enact H.R. 1205, the legislation sponsored by Mr. Rangel, Mr. Lehman and others and the companion bill, S. 459, Senators Hatch and Simon. This would mean that not just those parents who adopt some of the children with special needs but all parents who adopt legally, including all children with special needs, all domestic adoptions, all international adoptions, whether through public welfare agencies or local voluntary agencies, non-sectarian and sectarian alike would receive some sort of benefit. The Congress would be taking a substantial step toward eliminating discrimination against the children of all races and ethnic groups and physical conditions and ages who need homes, wherever they were born and whomever plans to adopt them. Right now, that discrimination exists and only a small fraction of those who adopt stand to receive any help.

And even if the bi-partisan and bicameral proposal I suggest you enact becomes law, there is still another step to be taken. That final step, which would eliminate the last inequities in the system of encouraging adoption, would be to enact a tax credit for adoption. We have been asked about the feasibility of this by some in Congress and have told them that, indeed, a credit would be ideal. There are some families whose incomes are such that they do not adequately benefit from a deduction. Some of these families are unlikely to be served through any of the mechanisms that are potential recipients of Federal assistance through the existing expenditure program. We recognize, however, that the likelihood of a tax credit being enacted is very small given the difficulty Congress has had in enacting a less generous and less comprehensive tax deduction measure.

I want to close by pointing out that any of these revenue measures should be examined with an eye to the very real savings to be obtained if, through a meaningful tax deduction law, the voluntary, non-governmental segment of the adoption and maternity services system can be again allowed to function. Deductions would allow non-governmental agencies to provide medical services to pregnant women and their babies and those expenses would be reflected in adoption fees, not in Medicaid expenditures. Deductions would allow non-governmental agencies to provide housing and job training and educational services and those expenses would be reflected in adoption fees, not in AFDC expenditures. Deductions would allow non-governmental agencies to provide social services and transportation costs and administrative services and training and the legal costs necessary to adoptions and those expenses would be reflected in adoption fees, not in uncontrollable administrative costs. The irony is that many of these same expenditures, if covered through donations to qualified charitable organizations, are now deductible. Why not allow the deduction if the expense the Federal government would otherwise pick up is paid for by adoption fees instead of outright contributions?

The costs of adoption and maternity services are being underwritten now, either directly when they are provided through existing Federal expenditure programs, most of which are entitlements, or through the Title IV-E program. What we are suggesting is that by simply allowing ordinary families to pay for private services themselves, through adoption fees which are deductible, you will stimulate the provision of more and better services to a broader group of children and families, at less net cost to the Federal Treasury. All in all that's a fiscal bargain. And most important of all, there would be more children going to more good homes faster. You would have struck a real blow for foster care and adoption reform and a real blow at the barriers to adoption that many of you have been aware of and have been battling for two decades.

On behalf of the National Committee For Adoption, I want to thank this Committee for all its efforts on behalf of children, and especially on behalf of your efforts to reform that foster care and adoption system. It is a system that has frustrated all of us. But by taking the President's good first step and broadening it to H.R. 1205, the bill authored by Mr. Rangel and his co-sponsors, you can finally turn frustration into positive action.

Mr. Anthony. Thank you, Mr. Pierce.

Mr. Gomperts.

STATEMENT OF VICTOR S. GOMPERTS, CHAIRMAN OF THE TAX COMMITTEE, U.S. TELEPHONE ASSOCIATION, AND DIRECTOR OF TAXES, NYNEX CORP., NEW YORK, NY

Mr. Gomperts. Thank you, Mr. Chairman.

I am Victor Gomperts, corporate director of taxes for the NYNEX Corp., a worldwide provider of telecommunications and business services.

Through its two telephone subsidiaries, NYNEX provides local telephone service to subscribers in New York and in New England.

I speak today on behalf of the U.S. Telephone Association, whose 1,100 member companies serve 99 percent of the Nation's telephone access lines. USTA members range in size from small independent local exchange companies to the large regional holding companies that were formed with the breakup of AT&T.

I am here to express USTA's opposition to the telephone excise tax, which the administration proposes in its 1990 budget to make permanent. The tax, last extended for 3 years beginning in 1988, is imposed at a rate of 3 percent on local and long-distance telephone service and on teletypewriter exchange service.

First of all, I want to note that the local exchange industry appreciates the difficulty Congress faces in trying to reduce the budget deficit. We understand that everyone is expected to bear their fair share of the burden, but the resulting fair share cannot be achieved through a tax that is by its very nature unfair. Accordingly, on behalf of our customers, we must strenuously object to this proposal, and we take this opportunity to express our hope that the Congress will allow the excise tax on telephone service to expire as scheduled.

Our opposition to the tax and to the administration proposal is based on three considerations.

First, we agree with the position of the previous administration which recommended in an August 1987 Treasury Department study [1] that the telephone excise tax be permitted to expire. The Treasury Department had three criteria for imposing an excise tax, all of which the telephone excise tax fails to meet.

Moreover, the Joint Tax Committee, in a 1987 study of revenue alternatives,[2] agreed in their pro and con analysis that there was no rationale for imposing the telephone excise tax, that the tax is regressive, and that an expiration of the tax would help to offset increases in the telephone subscriber line charge.

Second, the tax encourages bypass of the telephone network, creating upward pressure on residential rates.

Third, it is a regressive tax, and unlike water, gas and electric services, it is the only household necessity subject to a Federal excise tax burden.

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[1] Report to the Congress on Communication Services Not Subject to Federal Excise Tax, Office of the Tax Analysis, U.S. Department of Treasury, August 1987.

[2] Joint Committee on Taxation, "Description of Possible Options to Increase Revenues" (JCS-17-87), June 25, 1987.

In the past, the Treasury has employed three criteria to justify an excise tax. Under the first criterion, external social cost, the tax represents a reimbursement to society of the external costs associated with the product or service being taxed. For example, tax receipts on cigarettes might be used for cancer research. There is no external social cost associated with telephone service.

Under the second criterion, the tax may represent a user fee, which is imposed on a Government-provided service or product, such as an entrance fee to a national park. Telephone service, obviously, is not provided by the Government.

Under the third criterion, the tax may be characterized as a nondistortive consumption tax imposed on a product or service that is price inelastic. That is as service that is unresponsive to price changes.

The telephone tax and the associated administrative costs of collecting that tax result in higher rates to customers. Unlike consumers of luxury items, consumers of telephone service respond very predictably to price increases by reducing their usage. This phenomenon has been demonstrated frequently in regulatory proceedings throughout the country.

Clearly, none of the three criteria set forth by Treasury 2 years ago in order to justify an excise tax fits the telephone excise tax.

The major competitive problem with the telephone excise tax is that it encourages bypass, which results in lowering telephone utility revenues and increasing rates to consumers. While customers of regulated utilities are subject to the tax, those who bypass the local network are not. To put the two groups on equal footing, the bypassers should be taxed as well. However, application of a tax on bypass facilities would be difficult to administer and would require a different statutory framework than is used today for the regulated telephone industry.

The telephone excise tax is particularly unfair to consumers, in that it is regressive. It falls more heavily on low-income families. A telephone is not a luxury item and should not be taxed as one.

Second, it is imposed on a service that is a necessity of modern life.

Third, among the four basic household utilities—electric, gas, water and telephone—only telephone is subject to the excise tax.

For almost three decades, Congress has recognized that the telephone tax is not desirable as a permanent part of the tax structure. Congress has been trying to eliminate this tax since 1959. Nevertheless, since 1965, the tax has been extended seven times, each time as a quote, unquote, temporary revenue raising measure. It is time to stop this cycle and allow the Federal excise tax to expire.

Thank you for allowing me the opportunity to express the views of the USTA.

Mr. ANTHONY. Thank you, Mr. Gomperts.

Mr. Howe.

STATEMENT OF JONATHAN HOWE, MEMBER, NATIONAL AVIATION ASSOCIATIONS COALITION, AND PRESIDENT, NATIONAL BUSINESS AIRCRAFT ASSOCIATION

Mr. HOWE. Thank you very much, Mr. Chairman.

My name is Jonathan Howe. I am president of the National Business Aircraft Association. However, today I am here speaking on behalf of a diverse coalition of the aviation industry representing literally every segment of this important industry. We, for example, today are speaking on behalf of pilots, air traffic controllers, operators, users, and manufacturers. I believe it is virtually unprecedented that such a segment of the community should speak with a single voice on such an important issue.

I would like to, if I may, Mr. Chairman, to summarize my testimony and hit the salient points in the brief time we have.

First of all, I think it is important to recognize that we are here to request that the committee oppose the administration's proposal to repeal the automatic 50-percent tax reduction in aviation user fees scheduled for January 1, 1990. That is the so-called trigger tax provision.

We must recognize that taxes collected from aviation users must be used for improving the national air transportation system and not to mask the true size of the Federal deficit. Let us not forget how we got the trigger tax in the first place. You may recall, Mr. Chairman, that the trigger was a compromise offer instead of taking the trust fund off budget. You may also recall that the vote in the House to take the trust fund off budget failed by only a very, very small margin.

Indeed, I believe it was the wisdom of this committee that embraced the concept of the trigger as a means of not breaking faith with the American traveling public and a way of assuring that the user-derived revenue was spent for the purpose that it was intended.

Indeed, Congressman Pickle last August in hearings on the trust fund noted—and I would like to quote if I could just briefly from his statement because I think it goes to the heart of this issue—"We simply cannot continue to use the trust fund in order to meet deficit targets while neglecting our airports and air traffic control system." He went on to point out that the message from this committee is clear: We want these dedicated taxes used for their intended purpose, to ensure a first-class aviation system in this country.

Mr. Chairman, the dedicated use of trust funds is essential given the growth that we have experienced in air transportation and air travel in this country since deregulation. Just to cite a few figures quickly, prior to deregulation we emplaned 240 million passengers in this country. In 1988 this number had gone to 450 million. By the year 2000, estimates are that that number will exceed 700 million.

It is clear that it is imperative that we need to support the ever more strained aviation infrastructure in this country. I would suggest that anybody who travels by air in this country recognizes this all too keenly.

The trigger for January 1, 1990, can be avoided. I recognize that although it is not under the jurisdiction of this committee, but that nevertheless I think it is important to point out that a $420 million supplemental appropriation and perhaps with some later figures it may even be less than that, such a supplemental appropriation will result first of all in the needed improvements in our system being accomplished. Second, it will result in an additional $1.2 billion flow of revenues netting a $750 million flow into the Treasury that was not contemplated.

The repeal of the trigger and to continue taxes at the current rate constitutes a real breaking of faith with the aviation community and I might add would work to the economic detriment of the entire Nation because we are so dependent on the aviation infrastructure to ensure our continued competitiveness.

In conclusion, let me simply say that this is a win/win situation, Mr. Chairman. The American public can win because our system will be modernized. They will win because it will be modernized at no expense to the general taxpayer, and the Treasury will win because the Treasury will net $780 million that they had not planned on.

Finally, let us allow an industry which wants to pay its own way for improvements in the system to do just that.

Thank you very much, Mr. Chairman.

[The statement of Mr. Howe follows:]

STATEMENT OF JONATHAN HOWE OF THE
NATIONAL AVIATION ASSOCIATIONS COALITION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
APRIL 12, 1989

Mr. Chairman, members of the Committee, my name is Jonathan Howe and I am President of the National Business Aircraft Association, an association representing business aviation in the United States consisting of over 3,000 member companies.
I appear before you today however, as a spokesman for the National Aviation Associations Coalition, a coalition which over the years has grown more cohesive as the challenges facing aviation have become more severe. This coalition includes the:

Aerospace Industries Association,
Aircraft Owners and Pilots Association,
Airline Pilots Association,
Airport Operators Council International,
Air Traffic Control Association,
Air Transport Association of America,
American Association of Airport Executives,
Experimental Aircraft Association,
General Aviation Manufacturers Association,
Helicopter Association International,
National Aeronautic Association,
National Air Traffic Controllers Association,
National Air Transportation Association,
National Association of State
 Aviation Officials,
National Business Aircraft Association,
Regional Airline Association.

Their members and the employees of their member companies number in the millions. They cover the full aviation spectrum from inventors, engineers, federal employees, manufacturers, state aviation officials, private, commercial and air carrier pilots as well as airport and airline executives. They and the three out of four Americans who now fly pay the taxes levied for improving the airports and airways.

We have come together to request that the Committee oppose the Administration's proposal to repeal the automatic 50% tax reduction in aviation user fees as prescribed in Public Law 100-223. We strongly believe that the taxes that are collected from aviation users and credited to the Aviation Trust Fund, must be used for improving the national air transportation system, and for that purpose only. We strongly oppose any efforts to use the surplus in the Aviation Trust Fund to reduce the Federal deficit.

It is sometimes difficult for an industry, particularly one as diverse as aviation with our often conflicting points of view, to reach a common position. Nonetheless, our coalition, this wide-ranging group, has in fact reached a consensus. In February of this year we collectively wrote to President Bush and called upon the Administration to restore fiscal integrity to the Aviation Trust Fund by ensuring that monies collected from aviation users be spent for improving the national air transportation system. And for no other purpose!

In 1987 Congress considered taking the Aviation Trust Fund off budget, and thus, excluding the Trust Fund from the calculation of the deficit. During consideration of the Airport and Airway Revenue Act of 1987, an amendment to take the Trust Fund off budget was narrowly defeated on the House Floor by a vote of 197 to 202. Instead of supporting a move to take the Trust Fund off budget, while at the same time demonstrating good faith to the aviation community that the Trust Fund would not be used for deficit reduction, the Ways and Means Committee supported the so-called trigger tax provision. This provision, adopted by the Ways and Means Committee and ultimately enacted into law as a part of the Airport and Airway Revenue Act of 1987, was designed to assure a balance would be maintained in terms of Aviation Trust Fund receipts and disbursements. Specifically, if at the end of the first two years of the re-authorization cycle, the period ending September 30, 1989, the level of appropriations made from the Trust Fund for aviation purposes, does not reach at least eighty-five percent of the authorized level, then the trigger will go off and the aviation taxes will be cut in half. The 50% reduction in aviation taxes would take effect three months later at the beginning of the calendar year, on January 1, 1990.

These taxes include the 8% passenger ticket tax, the 5% freight tax, and the 12 and 14 cents per gallon fuel tax. When the trigger goes off on January 1, 1990 each of these taxes would be cut in half. For example, the 8% passenger ticket tax would drop to 4%.

The Administration has proposed to the Congress that the trigger provision be repealed, while at the same time it is permitting the surplus to accumulate from all the taxes that are collected and not spent. This strategy goes in the complete opposite direction of the premise underlying the concept of the trigger tax.

On August 11, 1988 Congressman Pickle's Subcommittee on Oversight conducted a hearing to review the operation and future status of the Aviation Trust Fund. At the hearing Congressman Pickle stated, "We simply cannot continue to use the Trust Fund in order to meet deficit targets while neglecting our airports and air traffic control system." Congressman Pickle went on to add, "The message from the Committee on Ways and Means is clear, we want these dedicated taxes used for their intended purpose -- to ensure a first-class aviation system."

The trigger tax plainly stands for the concept of truth in budgeting. Frequently, the Federal government is criticized for spending money it does not have. But in the case of civil aviation, the opposite is true. Over $6 billion dollars collected from aviation users sit idly in the Aviation Trust Fund, while the capacity limits of the aviation infrastructure are severely strained. Despite the urgency of these needs, past administrations and the Congress have allowed the multi-billion dollar surplus to accumulate for one purpose only -- to mask the true size of the Federal budget deficit. Very simply, covering up the deficit is the only reason why the Trust Fund surplus continues to grow while, at the same time, an ever lengthening list of critical aviation infrastructure needs goes unmet.

Our testimony is about fairness to aviation users. The 1987 legislation establishing the trigger mechanism requires that if the Government is not going to spend the authorized user fees collected, then the Government should not keep on collecting the taxes and the tax rate would be cut. The "trigger" was included in the legislation in an effort to restore faith with the aviation users who were willing to pay for airport and airway improvements, but instead, were seeing their taxes collected, while critical programs were going unfunded.

As you know, growth in aviation since airline deregulation has been phenomenal. The number of passengers enplaned has almost doubled -- from 240 million in 1977 to more than 450 million in 1988 with 700 to 750 million projected by the year 2000. With this rapid growth in demand, the FAA can at best play only a game of "catch up" in its attempt to provide adequate facilities. The Federal government's inability to spend Aviation Trust Fund monies in the face of this rising demand invites trouble, particularly with regard to maintaining aviation safety.

We in the National Aviation Associations Coalition are not asking for a reduced tax rate, or the granting of a tax credit. Our message is much more simple. We simply want transportation taxes that are collected to be fully spent to modernize and expand our national air transportation system. Aviation consumers have already paid into the Trust Fund for capacity, expansion and improvement of the aviation infrastructure, however that money is not being spent as intended. Instead, it is being hoarded.

The triggering down of the tax rates scheduled for January 1, 1990, can be avoided through an appropriation of an additional $420 million in the current fiscal year ending September 30, 1989. We fully appreciate that the issue of such a supplemental appropriation is not within the jurisdiction of this Committee, but rather the Committee on Appropriations. Nonetheless, if an appropriation of $420 million were enacted by September 30, 1989,the 85% threshold of appropriated monies would be met, the "trigger" would not go off, and the aviation taxes would stay as they are. By averting the "trigger", and thus the tax cut, the CBO estimates that an additional $1.2 billion in fiscal year 1990 of aviation user taxes would flow into the Treasury beyond the level that would be collected if the "trigger" went off. Consequently, this $420 million appropriation would result in a net benefit to the Treasury of $780 million ($1.2 billion minus $420 million = $780 million).

Mr. Chairman, the issue of often inadequate and inconsistent funding for the FAA has long been a contentious one. What is required now is a willingness to consider creative funding initiatives to break the impasse which has existed with regard to full funding of the FAA. In fact, we must take a comprehensive look at the Federal budget and funding process and seek to chart a course through it which will relieve pressure to divert essential self-support for the FAA. The Aviation Trust Fund has simply not worked as promised given the surplus, which in effect, represents an overpayment of taxes by users.

We believe that the solution may lie in creating special budgetary treatment for FAA funding. Such special treatment must protect both the Trust Fund portion of FAA funding, which represents the cost for non-governmental use of the system, as well as the General Fund contribution, which reflects the national defense and public benefit share of FAA costs. Such special budgetary treatment should include permanent or at least multi-year authorizations and coincidental appropriations. Such an approach, not unlike other innovative approaches utilized to fund special purpose governmental entities with unique operating needs, would provide a better means of assuring that funding for the FAA remains reasonably consistent with the demands being placed upon the agency.

In conclusion, we believe that the proposal to repeal the "trigger" represents the worst of all possible worlds. To repeal the "trigger" and continue to collect aviation taxes at the current rate, while at the same time refusing to spend the surplus to meet critical capacity needs, would break faith with the aviation consumer. This committee should not accept such a proposal, which in effect, would return us to the failed methods of the past where Trust Fund collections were hoarded. Rather than going down this failed path, a more enlightened approach, one which assures consistent funding, would represent a genuine, long-term solution to the problem of the Aviation Trust Fund.

The Committee on Ways and Means prides itself, and rightfully so, on discipline and the ability to make tough decisions. The Committee on Ways and Means frequently has to say "No" to those seeking a benefit from the Federal Treasury. Today, the National Aviation Associations Coalition seeks no special tax break or benefit. We only request that the Committee do its best to ensure that an industry, which wants to pay its own way for improvements, be allowed to do so.

I would like to thank the Committee for providing me an opportunity to express the views of the National Aviation Associations Coalition on this critical issue affecting the Aviation Trust Fund.

Mr. Anthony. Thank you, Mr. Howe.

Mr. Toohey.

STATEMENT OF WILLIAM D. TOOHEY, VICE CHAIRMAN, TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL, AND PRESIDENT, TRAVEL INDUSTRY ASSOCIATION OF AMERICA

Mr. Toohey. Thank you, Mr. Chairman. Good afternoon.

It is a privilege to meet with you today to discuss the proposed imposition of user fees on international tourists to the United States for the purpose of providing funding for the U.S. Travel and Tourism Administration in the Department of Commerce.

I am William Toohey, and I am president of the Travel Industry Association of America and vice chairman of the Travel and Tourism Government Affairs Council, and it is on behalf of the council that I appear before you today.

The council is an affiliate of the Travel Industry Association and consists of 31 major national travel and tourism organizations. It officially represents the entire industry on Government issues of common concern. We have submitted a prepared statement for the record, and let me just briefly summarize our major points.

The council is proud to speak for the travel and tourism industry, that is one of the most dynamic and productive sector of our economy. This industry is our Nation's second largest private employer. As our largest export, it plays a vital role in our international trade performance.

Yet the travel and tourism industry has the potential, and our Nation has the need, for travel and tourism to make a much greater contribution to our balance of trade. Despite record numbers of foreign visitors, the United States has actually lost its world market share in tourism, and last year it suffered a $5.7 billion tourism trade deficit.

Part of the reason for our failure to realize our international tourism potential is the chronic underfunding of the U.S. Travel and Tourism Administration. In the last fiscal year, that agency received a general revenue appropriation of $13.8 million. The nations with whom we compete for international tourism dollars typically spend 2 to 3 times that amount.

In our view, USTTA's budget represents a modest investment in the promotion of America's largest exporter to the benefit of States, cities, and hundreds of thousands of small businesses across the country who otherwise would not be in a position to penetrate international markets on their own.

But, Mr. Chairman, our industry does not believe such funding should come from user fee approach proposed in the President's budget. We have several objections to taxing international arrivals to fund our Nation's international marketing program.

First, the burden of collection and enforcement would fall inequitably on one segment of the industry, the airlines while the benefits of the program would go to all components of the tourism industry. Second, the results of a truly effective international marketing program would benefit our entire Nation through more jobs and improvement in our balance of trade, and therefore a stronger

American dollar. Therefore, we maintain it should be funded by the entire Nation from general revenues.

Third, Mr. Chairman, we confess to a certain level of skepticism about the likelihood of such user fee revenue going exclusively and entirely to its intended purpose. As our friends in the airline and highway industries know all too well, trust funds are often not used for their designated purposes.

Finally, we would note that such a user fee would seem to violate the spirit of the 1981 National Tourism Policy Act by actually creating a disincentive in the form of higher costs to the free and welcome entry of individuals traveling in the United States as the legislation calls for.

For these reasons, the travel and tourism industry must oppose the reliance on user fees to fund the USGTA.

Mr. Chairman, thank you for your time and for the opportunity to appear before you today.

[The statement of Mr. Toohey follows:]

Statement Presented by:
William D. Toohey
Vice Chairman, Travel and Tourism Government Affairs Council; and

President, Travel Industry Association of America

Good morning Mr. Chairman and members of this Committee. It is an honor and a privilege to have this opportunity to meet with you today to discuss the proposed imposition of user fees on international tourists to the United States for the purpose of providing funding for the U.S. Travel and Tourism Administration.

My name is William D. Toohey, and I am President of the Travel Industry Association of American (TIA). I am also Vice Chairman of the Travel and Tourism Government Affairs Council and it is on behalf of the Council that I appear before you today. The Council, an affiliate of thq Travel Industry Association, consists of 31 major national travel and tourism organizations and officially represents the entire industry on government issues of common concern.

It is our industry's demonstrated ability to create economic opportunity that we believe is one of the most compelling arguments for an effective and well-funded national tourism development program. We support the U.S. Travel and Tourism Administration (USTTA) in its effort to promote the whole of America and its thousands of destinations and attractions throughout the world, thereby increasing U.S. export earnings, tax revenues and employment derived from international tourism.

Travel and tourism is currently the second largest private employer in the nation and the first, second or third largest employer in 80 percent of the states. It also makes a major contribution to federal and state government treasuries. Domestic and international travel generated $18.5 billion in federal tax revenues and $11.5 billion in state tax revenues in 1987.

In addition, international tourism plays an absolutely crucial role in our national trade performance. Travel and tourism is now America's largest export. Indeed, a significant portion of the tax base of many states is derived from revenue generated by foreign visitors. Illinois, for example, earned $55 million from international tourism. Texas, $167 million; Florida, $215 million; and New York, $273 million.

Yet, because the number of Americans who travel abroad far exceed the number of foreign visitors who come here, America suffers a $5.7 billion travel deficit. Moreover, the world-wide tourism market is growing and America's share of that market is shrinking. Our market share in 1988 was 9.2%--the lowest market share in over ten years. We are convinced that the reason for that decline is due largely to our inability to effectively compete with the very aggressive and highly visible marketing programs of other national governments.

In presenting its budget for fiscal year 1990, the Administration announced plans to seek legislation which would propose funding USTTA through a user fee collected from international air and cruise ship passengers. This fee would, in theory, protect the USTTA from a long history of efforts by the OMB and various Administrations to zero the agency out of the federal budget.

Mr. Chairman, our principal objection to a $1 a head user fee is that despite all the protestations that it is a negligible fee relative to travel costs, it is in fact another in a long line of "fees" and "charges" that are supposed to be tolerable merely because they are, individually, still single-digit line items. The number of such fees that are already borne by travelers would be far too numerous to attempt to list here, but they are extensive, and the fact that tourists are the single favorite target seems to stem largely from the fact that they are personally on hand to empty their wallets. Air and sea travelers already pay, for example, a $10 fee for federal inspection services fees--an amount far above the cost of providing the inspection.

Furthermore, virtually none of these fees, already collected, have been applied to their designated purposes. Nearly all have been diverted to general revenues, or allowed to languish in a "paper fund" to disguise the enormity of the federal budget deficit. The Aviation and Highway Trust Funds are two of the most egregious samples of this kind of fiscal shell game.

The Airport and Airway Trust Fund, for example, was originally established in 1971 to improve capital development for aviation. Instead, the Fund has accumulated a surplus in tax revenue and interest income now totalling $6 billion. Clearly, users of the aviation system are not receiving the benefits of the improved and modernized system for which they have already paid. Given this experience, and many others that are similar, the travel industry and its customers cannot be blamed for approaching so-called user fee proposals with both suspicion and trepidation.

Mr. Chairman, the travel and tourism industry understands the seriousness and enormity of the federal budget deficit. Difficult decisions must be made. However, we believe that these deficits cannot be cut significantly and permanently unless economic opportunities are created. Travel and tourism is one such opportunity and one which ought to be fostered. A user fee such as this will have a counter-productive effect on tourism trade development.

Furthermore, I would remind this Committee that the National Tourism Policy Act of 1981 which created the U.S. Travel and Tourism Administration established a mandate to "encourage the free and welcome entry of individuals traveling to the United States." We believe that the fee proposal is at odds with the intent of this mandate and as such will not contribute to international good will toward the United States. Plainly, USTTA's programs are a national benefit, and the cost should be borne by the entire nation.

Mr. Chairman, thank you for your time and the opportunity to appear before your Committee today.

Mr. ANTHONY. Thank you, Mr. Toohey.

I have a few questions of the witnesses, and Mrs. Kennelly might have further questions. I will be happy to recognize you in just a moment, Mrs. Kennelly.

Mr. Toohey, if you could be assured that the proceeds of the proposed fee would be used to promote U.S. tourism, would your organization at that point support the imposition of the fee?

Mr. TOOHEY. I would think that such an assurance would certainly remove one of the objections that the travel industry has to a proposed user fee. The question of equity, however, would still remain. And I think that would pose a difficulty for the travel industry generally in supporting a user fee concept.

Mr. ANTHONY. What do you think foreign countries would do if there were such a type of user fee imposed on the tourist industry?

Mr. TOOHEY. There is always the possibility of reciprocal action because the vying for foreign exchange earnings through tourism is really an international combat between governments. That is what our Government does not seem to recognize. It is not a private sector role to promote an overall country. It is the government's role to that and other countries recognize that.

So there could be some penalties imposed on U.S. citizens traveling abroad if we attempted to impose a tax on tourism to the United States.

Mr. ANTHONY. Mr. Gomperts, I wish you would better explain to me what a bypass facility is.

Mr. GOMPERTS. Certainly, Congressman.

The term bypass, as it is generally used today, refers to a situation where for instance a large corporation which would have offices or manufacturing facilities in different locations within a State or in different States rather than continue to use the local telephone system that is provided by the local carrier or the interstate telephone facilities of AT&T or MCI would construct its own facility from top to bottom, that is it would put up its own microwave towers, have its own switches, its own telephones, in fact would have its own telephone system.

By doing that, companies are able to bypass—and that is where the word comes from—the local interstate telephone facilities of the dominant carriers, and in effect not pay any charges to the local companies. By so doing they of course decrease the revenues of the local companies. They are no longer customers. When those revenues decrease, the expense of the company does not go away. The result of that is that the people left behind, that is the residential customers who can never bypass and the other corporations that cannot afford to bypass, end up having to pick up the expenses that are left behind by the bypassers.

The point of my testimony was to the extent the excise tax figures in that decision, it is one of the facts, one of the costs that a company looks at, it would encourage them, along with other factors, to bypass the local phone system. In that sense, we think that over the long term that certainly is not the trend that we would want to see develop.

Mr. ANTHONY. How widespread is the practice, the bypass facilities, how broad is that practice?

Mr. GOMPERTS. Well, a few years ago had you asked me that——

Mr. ANTHONY. Where is the line heading?

Mr. GOMPERTS. Well, a few years ago had you asked that I would have said it is really in its infancy. Today though I have heard from different companies around the country—and again it depends on different regions—that they have lost as much as 10 percent of revenues last year to bypassers. In the New York area where New York Telephone operates and the company I am affiliated with, there is a very large bypass facility which is owned by Merrill Lynch along with a few other partners, and they have extensively bypassed the local telephone network for many of the largest banks and other financial institutions.

So this is not simply one of these threats that in fact is not there. It is there today, Congressman, and it is only getting worse. It is truly a threat to the local and interstate phone companies.

Mr. ANTHONY. Could a definition be drawn that would clearly identify the bypass facility and the services that are being provided sufficient enough that we—the committee might entertain including them in the excise tax?

Mr. GOMPERTS. The problem with that, Congressman, is two-fold. First, when a company bypasses the phone system, it goes out and it purchases certain equipment, computer equipment and other such things in order to do the bypass. The purchase of the equipment, even if you were to create a tax structure that would, in effect, identify the equipment, that is define it so that it would withstand a statutory challenge, and, in fact, you taxed it, it would be a one-shot tax. The companies that stay with the phone company, they would pay an excise tax on a continuing basis, month in and month out, forever.

The second problem is the definition. The equipment used to bypass the phone system—and as I am sure you are aware, the phone system today is really nothing more than a large computer in many ways, looks a lot like the type of computer equipment that you might acquire to do your billing, your processing in your office, or other such things.

It would be very hard to come up with a statutory structure that would identify at the source whether a computer or similar equipment is being purchased for office use or, in fact, to bypass the phone system. What I am saying in another way is the administration of such a provision, enforcement by the IRS as a practical matter would be impossible. I think you could theoretically construct a statute that would do it, but the enforcement would be as a practical matter not possible.

Mr. ANTHONY. I find that whole area to be very fascinating. Obviously, I have got a little—a lot of reading to do on the technological side of it. It appears that you have identified a problem, and a growing problem. Maybe we should take a closer look at it.

Mr. Howe, you mentioned that the user fee should be utilized for rebuilding the infrastructure that is being stretched probably beyond its limits at the moment. I must tell you I do travel quite a bit, and it appears that we do have an awful lot of capital improvements that we need to make.

There is an important concern other than capital expenditures, that being aviation safety. I was curious as to whether or not you would support use of a surplus of the trust fund for airport safety operating costs such as salaries of air traffic controllers and airport security personnel inasmuch as security is really on everybody's mind at the moment?

Mr. HOWE. Well, Mr. Chairman, I think first of all, perhaps a little history is appropriate. Certainly I would agree with your premise that it is imperative that this money be used for the many critical projects to modernize the system.

Historically, the trust fund was designed as a capital improvement fund. Of course, our position is that first and foremost it must continue to be used for the capital modernization of the system. However, I think it is fair to say that all of the members of our coalition several years ago acquiesced in the use of some portions of those moneys for the FAA's operating budget including payment of air traffic controllers and other safety type of personnel. We would continue to support that proposition.

I think it is important though to recognize that the original purpose of this trust fund, and the most critical purpose of this trust fund is the modernization of the system and that also obviously the air traffic control system in this country and the safety system in this country operates for the support of all citizens, the national defense, and there is a broader base of contribution, if you will, than just to the users of the system.

But in answer to your question, we have supported and would continue to support moneys from the trust fund being used for critical safety purposes, air traffic controllers, rather than simply sitting there and building up into an ever-increasing fund in the trust fund.

Mr. ANTHONY. Thank you.

I would just say to Mr. Pierce, I do not have any questions for you, but I would just say to you we have got to find a way to solve the adoption problems that we have in this country. It is a shame that we have a lot of families that do not have children, want families, and we seem to have such a backlog in certain instances. So I applaud you in your efforts to try to tackle that problem.

Are there any other members of the committee that have questions or seek recognition?

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Anthony.

Mr. Pierce, thank you very much for the work you have done on this whole question of adoption. I think some of us are as disappointed as you are that things did not work out the way we had hoped they would a few years ago.

However, as you are aware, we have incredible fiscal restrictions on us. I know that many people come before this committee because they figure a tax credit does not count toward the deficit, but we know differently.

So I would just like to throw out a suggestion and ask for your reaction since we are in this bind. What about the phase out of the deduction recommended in the Bush proposal? Would you agree that we could phase the deduction out for better off families since we have this budget crunch? Would that be acceptable to you, that as a family had more income, they would not be able to get this new deduction?

Mr. **Pierce**. I think that when we have a problem with the deficit, that it is fairer to say that people who have incomes over $60,000 a year should not get the same benefit, and it should be phased out. If you wanted to phase that out, people that had a more modest income, that would be fine.

Mrs. **Kennelly**. See, that is the point. I do not want to. I am wrangling with this as you have. I am just wondering what we could figure out to help it without doing the whole thing—let me take the dollar approach. Let me take it from another approach.

You suggest that we forget a deduction just for special needs children and we allow one for all adoptions. Are there any special needs children that you think might be allowed to retain that category because they are in fact special needs children?

Mr. **Pierce**. Well, some of the toughest children, as you would probably remember from your time on the board of Catholic Charities in Hartford, are the older children. The older children are legally in the custody of the State. But the people who we usually find to get homes for them are found through sectarian and nonsectarian agencies because that is where the parents come. So I would suppose those would be the toughest kids of all.

I mean, we can find a home today, if we can get them out of the court system, for black infants with AIDS. But if you have a 14-year-old child who has been abused and has been in 15 foster homes and is a firesetter and a bed wetter, and who is violent, that is an extremely difficult child to find a home for. So that I think you could leave the real special special needs kids like that in the category.

The other kids, I think, could be in the other category. If what you are suggesting, Mrs. Kennelly, is that we have a two-tiered system where we have extra help for the really tough kids——

Mrs. **Kennelly**. I think that is what I am suggesting. That is why we originally began that concept, if something is difficult, you give a little extra.

Mr. **Pierce**. Right.

Mrs. **Kennelly**. See, what I am afraid of here, sir, if we go along now with your proposal, we are going to lose what we originally intended to help get those really tough kids to be adopted. And that is why I am suggesting maybe we should carve out the special special needs.

Mr. **Pierce**. One of our real problems, Mrs. Kennelly, is that the State public welfare agencies, no matter how well-intentioned they are, are so burdened down by administering AFDC and so burdened down by trying to respond to child abuse and neglect, that they cannot get anything done in foster care and adoption. They try to work through the private agencies, like the ones you are familiar with, but they do not recognize their role and they cannot get things working.

All these years later, after the original work that we did when the 1981 bill passed, we could not get anything through the system. So the beauty of the tax deduction system is that it allows the private agencies, church related and nonchurch related to use volunteers and a lot of other resources that we just could not use any other way.

The States have not responded in 3 years to our other rate for funding. And it is a real disappointment to all of us.

Mrs. KENNELLY. Well, Mr. Pierce, let me tell you something. I have been very active in child support enforcement both in the 1984 amendments, and again in welfare reform. And I get the same answer from the States about child support enforcement—we are so busy with this, we are so busy with that, we cannot emphasize child support enforcement.

Then I review your testimony on adoption with the same frustrations that I have with child support. Do you really think that the States do not have time, or has it just never been insisted on by anybody that it become a priority? I mean, are they just saying that or is it in fact true?

Mr. PIERCE. I think that genuinely they are overwhelmed. Today the schools of social work, Mrs. Kennelly, are not turning out people who know how to deal with adoption. In the public agencies, they have very few people who are even competent to deal with it. They are dealing with putting out fires, and the adoption/foster care issues are complicated and sophisticated. They do not have the people that can deal with those issues. They are busy trying to find beds for people who have been burned out of their homes.

Mrs. KENNELLY. So what you are saying to me is that if the States cannot do it, let us go back to the private agents where we were originally, give them something in the Tax Code to help them, and they will pick up the burden?

Mr. PIERCE. Right. As I understand the President's proposal, he would leave the existing revenue program in place, which would be OK for the public agencies. If they can ever get their act together, that would still be a revenue stream that they could use. Meanwhile, let us use the tax deductions for the voluntary sector.

Mrs. KENNELLY. Well, I have got to tell you something. We cannot accept your whole proposal because we just do not have the dollars. But I look forward to talking to you more on what we could do to at least carve out a piece and maybe we can improve it. I think we are all disappointed in where we are. We all tried, and we seemingly did not anything.

I appreciate what you have done. I thank you for being so nice in your testimony, to say it as nicely as you have. Thank you.

Mr. PIERCE. Thank you, Mrs. Kennelly.

Mr. ANTHONY. The Chair would like to thank this panel for its contribution, as all witnesses today. The committee will stand in recess, to meet at 9:30 tomorrow when we will take up two proposals, one on capital gains and one on the Medicare proposed tax.

Thank you, stand adjourned.

[Whereupon, at 2:02 p.m., the committee adjourned, to reconvene at 9:30 a.m., Thursday, April 13, 1989.]

REVENUE PROPOSALS CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

THURSDAY, APRIL 13, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman **Rostenkowski**. Today the Committee on Ways and Means continues hearings on the review of revenue proposals contained in President Bush's budget for fiscal year 1990. The committee is scheduled to receive testimony from public witnesses on the tax treatment of capital gains and the proposed extension of the Medicare payroll tax law to State and local government employees.

Yesterday, the committee heard testimony from several witnesses on the capital gains tax rate reduction in the President's budget proposal. Today, we continue to explore the questions first raised in yesterday's hearings about the fairness of revenue implications of this proposal.

We'll also receive testimony about the specific impact of the proposals on forestry and the forestry, real estate securities, and electronics industries as well as other sectors of the economy.

The capital gains rate enacted in 1986 was a critical part of the overall goal of making tax reform a fair deal for middle-class income families rather than a bonanza for upper income taxpayers. It is important that we scrutinize very carefully any proposal that signals a retreat from this goal.

I'm pleased to welcome the cochairs of the Forestry 2000 Task Force, Congressman Ron Wyden, Congressman Sid Morrison, Congressman Sonny Callahan, and Congressman Lindsay Thomas. Welcome gentlemen, it's always a pleasure to have you share your views with us.

If you're ready, the committee is ready to take your testimony. Mr. Wyden.

STATEMENT OF HON. RON WYDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON, AND COCHAIR, FORESTRY 2000 TASK FORCE

Mr. **Wyden**. Thank you very much, Mr. Chairman. It's a pleasure to be here with you.

Mr. Chairman, I would ask unanimous consent that my remarks be made a part of the record and, perhaps, just summarize.

Chairman **Rostenkowski**. Without objection. All the testimony that you have written and made available for the record will be included in addition to your oral testimony.

Mr. **Wyden**. Thank you very much, Mr. Chairman. I do appreciate the chance to be here with our colleagues who are part of the Forestry 2000 Task Force, the bipartisan group of more than 115 Members of Congress. Mr. Chairman, with your indulgence we'll all touch on a few of the principle points. Let me, if I might, just begin very briefly.

Mr. Chairman, it's my view that the loss of capital gains radically changed, for the worse, the economics of tree growing in our country. For 4 million small woodlot owners in this country, the change in capital gains has been absolutely devastating.

Now, until 2 years ago, Mr. Chairman, as you know, only 40 percent of the tree growers capital gains were subject to tax. Now 100 percent is subject to the tax. As a result, in my home State, Oregon tree farmers have seen their taxes double and in some cases, quadruple according to a survey that was done by a 1,000 Friends of Oregon, which is a conservationist group.

Timberland, like any other asset, is valued according to its expected cash flow. This big tax increase has had a devastating effect on the value of timberlands in our Nation. Oregon's nonindustrial woodlots alone have declined in value by more than $200 million in the last 2 years. That's a loss due entirely to the increase in the capital gains rate.

Now, in our State that translates into about $93 per acre, an average loss of $10,800 per landowner. In many cases this will reduce the land's timber resource value to zero and the activities won't pencil out any longer. The land is going to be put to other uses and the wood products industry loses forever a source of trees.

Mr. Chairman, the other point that I wanted to mention is that we are seeing, in the Pacific Northwest a tremendous economic upheaval in Oregon and Washington, my home State and that of my colleague Sid Morrison. Some 38 mills have closed in the last 8 months, throwing out of work some 3,100 employees. Now the problem is there simply aren't enough logs available to keep all mills operating. We think it's absolutely essential that for growing timber, which is a risky and long-term investment, that there be reasonable tax policies.

The other thing that is so important about tree growing is that in this area there just isn't a corresponding ability, Mr. Chairman, to make adjustments in holdings. That can be done in other areas, stocks and bonds and things of that nature. But you just can't do it in the tree growing business because trees are in the ground, in some cases they're planted decades ago in certainty of an unchanging capital gains policy. So the investments with respect to tree growing and the small woodlot operators of the Nation were literally rooted in place and it's the view of these individuals that the rules were changed in the middle of the game.

Mr. Chairman, the only other point that I would want to mention at this point is that I think that there's considerable support among the members of our task force as well as our colleagues generally about going after abusive tax shelters. This group that the Forestry 2000 Task Force, carries no brief for the abuse through tax shelters and the like. But I would just hope using the expertise of this committee and the input that we can give representing the forestry group that we can go after the shelters, go after some of these big business boondoggles that shouldn't receive favorable tax treatment, while at the same time not eliminating favorable tax treatment for long-term risky investments such as the Christmas tree farming and small woodlot management.

Mr. Chairman, I said I wouldn't give a filibuster and I appreciate the chance very much to be with the committee. Our colleagues, of course, have additional points that they wish to make and we just thank you for the chance to be with you and to offer our views.

[The statement of Representative Wyden follows:]

HEARING STATEMENT
REP. RON WYDEN

PROPOSALS TO LOWER TAX RATE ON CAPITAL GAINS

BEFORE THE HOUSE COMMITTEE ON WAYS & MEANS

APRIL 13, 1989

MR. CHAIRMAN, thank you for this opportunity to speak on proposals to reduce the capital gains tax rate. This is a subject of crucial importance to American industry and American workers.

We believe a lower capital gains rate will encourage long-term investment, and thereby strengthen a number of hard-pressed U.S. industries. That lower rate is absolutely necessary for owners of private timberland, and for the regional economies that depend on trees from those lands for industrial raw material. These woodland owners oversee most of our nation's forests. Their timber is the plasma that pumps life into mills and manufacturing jobs in more than 40 states.

Mr. Morrison, Mr. Thomas, Mr. Callahan and I are co-chairmen and co-founders of the congressional Forestry 2000 Task Force. The 116 members of Congress within our organization share a common interest in the stewardship of our private and public forestlands. The Task Force was founded in early 1987. In part it was a concerned response to the effects of taxation on timber and timber owners.

The importance of our timberlands goes beyond the hundreds of thousands of jobs they support. If we manage these forests properly we will help preserve wildlife habitat and watershed, recreational values and related aesthetics for future generations.

But as a source of timber, these private forests have never been more important. In Oregon and Washington, home to Mr. Morrison and I, some 38 mills have closed in the last six months, throwing out of work some 3,100 employees.

The cause: There's simply not enough logs available to keep all mills operating.

And by all many accounts, the situation is likely to get a lot worse before it gets any better. We in the Pacific Northwest are facing timber shortages of unprecedented proportions, and the people who pay the price will be mill families and mill towns.

Small woodlot owners provide about 9 percent of the timber processed in Oregon mills, and their contribution is growing as a percentage of the total. Their contribution is important, now. It will be vital in the future.

For the 4 million small woodlot owners across this country, growing timber is a risky, long-term investment. It takes up to 50 years for a softwood tree to reach harvestable size. During the interim, those trees are subject to the ravages of fire, windstorm and insects, and even bears who chew the young saplings.

And that is why tax treatment for timber growing is so important. Without reasonable advantages, private woodland owners will be less inclined to plant new trees after they harvest the old ones. And they will be less inclined to maintain those lands in long-term forest management. Until two years ago, only 40 percent of the tree grower's capital gains were subject to tax. Now, 100 percent is taxed. As a result, Oregon tree farmers have seen their taxes double, and, in some cases quadruple, according to a survey by the 1,000 Friends of Oregon, a conservationist organization.

Timberland, like any other asset, is valued according to its expected cashflow -- how much money it will produce. This big tax increase has had a devastating effect on the value of timberland. Oregon's nonindustrial woodlands, alone, have declined in value by more than $200 million in the last two years -- a loss due entirely to the increase in the capital gains rate.

That translates into about $93 per acre, an average loss of $10,800 per landowner. In many cases, this will reduce the land's timber resource value to zero. The activity simply won't pencil out. The land will be put to other uses, and the wood products industry loses forever a source of trees.

Mr. Chairman, let me cite the example of Clyde and Norma Ramsay, of Mollala, Oregon, a small town just outside my home district. The Ramsays are among Oregon's 18,000 small timber owners. They began planting trees on their 700-acre farm 35 years ago. In many ways, they are typical of the tree-farming business. They became tree farmers in part through a capital gains rate reduction instituted in the mid-1940s to encourage this kind of long-term investment.

Only now are the Ramsays beginning to harvest their first trees, after decades of nurturing and tens of thousands of dollars of investment. Like many of their neighbors, they will be hard-pressed to show a profit, thanks in part to a huge increase in their tax bill. Oregon state law requires them to re-plant everything that is cut, and that could put them into a money-losing situation.

Just to create enough cash-flow to pay their tax bill, they will be harvesting some additional trees that are not yet mature. That means a heavy loss of potential value for those younger trees. Ultimately it's another loss of fiber for Oregon mills.

Finally, the Ramsays say can't afford to do pre-harvest trimming, which means that trees harvested in the future are going to be smaller and less valuable. And our mills lose even more fiber.

Norma Ramsay has told my staff that she feels the federal government has "broken faith with the tree growers." She and her husband, and thousands of others just like them, feel that the capital gains rate increase in her words, "pulled the rug out from under us."

The loss of capital gains radically changed for the worse the economics of tree growing, just as it did with all other assets, but without the corresponding ability to make adjustments in holdings with the ease that stocks and bonds enjoy. Trees are in the ground, in some cases planted decades ago in certainty of an unchanging capital gains advantage. Those investments and costs were literally rooted in place. And the rules were changed in the middle of the game.

For small woodlot owners the increase in capital gains rates was part one of a double-whammy. Part Two has been the loss of normal business expense deductibility.

A non-corporate woodlot owner can't even deduct the cost of a gallon of gasoline for his chainsaw, or the consultation of a professional forester in planning sustainable harvests. I hope that at the proper time committee members will give full consideration to H.R. 1086, legislation which will remedy this inequity. The bill is a limited correction -- a surgical procedure -- to give these business persons reasonable

Mills are closing in Oregon and throughout the Pacific Northwest for want of harvestable trees. That's a human tragedy for both families and towns utterly dependant on those mills. The federal government gets hammered as well. Lost wages, lost jobs and closed mills will cut federal tax collections, a point committee members should weigh when they assess the impact of various capital gains rates.

Anything which further diminishes the number of trees available for harvest may be, in effect, the pink slip signature for thousands of workers in the wood products industry.

Tax reform took aim at abusive tax shelters. We have no brief for those shelters. But let's go after them one-by-one, using this committee's excellent expertise and offices. Abuses, and tax shelters, and big-business tax boondoggles should receive a swift, regulatory execution. But eliminating favorable tax treatment for long-term, risky investments such as tree growing hurts industry, workers and the environment. It throws the baby out with the bathwater. And it has a particularly onerous impact on timber-producing states such as my own.

At the very least, persons who already have investments in the ground should be exempted from this tax rate increase. As Mrs. Ramsay argues, we cannot break faith with these citizens. A more far-sighted approach, I believe, would be to continue favorable capital gains treatment for economically vital activities such as tree growing.

Mr. Chairman, the U.S. wood products industry plays a major role in our economy. Last year, shipments totaled more than $190 billion, and more than 1.4 million people were directly employed by wood products manufacturers. Another 7 million Americans are timber growers.

It's a big industry. But it's health is keyed to robust economic growth and long-term investment -- in houses, in manufacturing plants, and, most importantly, in trees. From 1944 until 1986, Congress recognized timber as a capital asset by providing a reasonable capital gains differential for just this sort of long-term investment. It encouraged a much higher level of reforestation, and it helped our industry better compete in global markets.

With the United States embattled on many fronts by rising trade deficits, now is not the time to remove the lower capital gains rate incentive.

STATEMENT OF HON. SID MORRISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON, AND COCHAIR, FORESTRY 2000 TASK FORCE

Mr. MORRISON. Thank you, Mr. Chairman. I appreciate this opportunity to appear, especially with this group as we've worked together for the last few years on this Forestry 2000 Task Force project.

The Presidential campaign certainly brought to the forefront the capital gains issue. I'm delighted that you're holding these hearings and giving some consideration to special approaches to encourage Americans to invest.

My good friend from Oregon, our friend Les AuCoin, and I have introduced a package. We think our approach is better than that the President proposes, primarily because our approach creates a three tiered capital gains rate differential for incomes at all income levels. The President's 15 percent proposal, we feel, leaves out the lower rung of American investors and we want to encourage everyone, encourage individuals at all income levels to invest in the long term.

Also, under our proposal the longer an asset is held, the more favorable tax treatment it receives. We utilize the procedure that might have come initially from your colleague, our friend, Bill Archer, in which a 40-percent exclusion on 1 year investment, 60 on 3 and 100 on anything held over 5 years would reduce the corporate capital gains tax rate from 34 to 20 percent and would apply to all historical assets with the exception of collectibles.

Since we're here representing timber efforts, both from the small wood lot owners to some of the larger corporations, I just want to repeat that timber growing is a long-term investment. We've gone back and forth like a pendulum in the treatment of capital gains on timber. They were enacted by Congress in 1944 resulting in a dramatic increase in reforestation and timber management and reversing the cut and run approach practiced by timber investors prior to 1944.

Of course, we all express concern that this feature was lost in the Tax Reform Act of 1986. I feel the failure to reinstate the capital gains treatment for timber income will affect the investment decisions of thousands of family-size wood lot owners. They own 60 percent of our Nation's forest land and ultimately the Nation's future supply of timber.

Also going back and forth, Mr. Chairman, like a pendulum is what we have done in the harvesting of timber acres in this country. For a number of years we cut almost exclusively private lands. In recent decades the shift has been to public lands. A lot of that timber supply is virtually gone. We're almost finished with old growth timber and there's conflict over what's left. It's essential for America's fiber supply that we bring that pendulum back to private lands and tax policy certainly is important to that.

In my district, which is relatively dry but heavily forested, it takes 100 years to grow a commercially viable tree. Of course, we're also interested in the greenhouse effect and global warmings. I think you have a unique opportunity through legislation like the Capital Investment Act of 1989 to provide the pool of venture capital, to create new jobs, to enhance our competitive position and, of course, to keep those trees growing.

We thank you for the opportunity to appear.

[The statement of Representative Morrison follows:]

STATEMENT OF THE
HONORABLE SID MORRISON
BEFORE THE COMMITTEE ON WAYS AND MEANS
ON THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL
AND
THE CAPITAL INVESTMENT ACT OF 1989
H.R. 1029

APRIL 13, 1989

Mr. Chairman, I wish to begin by expressing my appreciation to you for holding this hearing and for providing me and my fellow co-chairs of the Forestry 2000 Task Force with the opportunity to present our testimony before your Committee.

In February, President Bush put the capital gains issue back before the American people and the Congress with his budget proposal for reducing the capital gains tax rate for individuals. While I applaud his initiative, I would like to draw your attention to legislation introduced by myself and Congressman Les AuCoin with the support and cosponsorship of the Task Force co-chairs. I believe our legislation will do a better job at encouraging long-term investment, stimulating the creation of new jobs, and promoting the nurturing of our nation's privately-owned forests.

The Capital Investment Act of 1989 (H.R. 1029) would establish a three-tiered capital gains rate differential for individuals at all income levels. Specifically, this legislation would exclude from personal income tax 40 percent of the net gain on investments held for one year, 60 percent of the net gain on investments held for three years, and 100 percent of the net gain on investments held for five years. It also would reduce the corporate capital gains tax rate from 34 to 20 percent, and would apply to all historical assets with the exception of collectables.

The difference between the President's flat-rate proposal and ours is simple: our goal is to encourage individuals at all income levels to invest in the long-term. Under our bill, the longer an asset is held, the more favorable tax treatment it receives. Investors will thus have an even greater incentive to invest in long-term, productive ventures--particularly in those small, start-up companies that provide the vast majority of jobs in this country--as opposed to speculative, short-term investments. In addition, by restoring the capital gains treatment of timber-generated income, our proposal will provide the tax incentive necessary to promote the health, productivity and environmental stewardship of America's forests.

Timber growing is a long-term investment with substantial risk from fire, disease, wind and other natural occurrences. As you know, capital gains treatment of timber was enacted by Congress in 1944, resulting in a dramatic increase in reforestation and timber management and reversing the "cut and run" approach practiced by timber investors prior to 1944. Like many members of the Forestry 2000 Task Force, I expressed concern about losing the long-standing capital gains protection for timber resources in the Tax Reform Act of 1986. Failure to reinstate the capital gains treatment for timber income will affect the investment decisions of thousands of family-sized wood lot owners (who own 60 percent of our nation's forest land), and ultimately, the nation's future supply of timber.

Perhaps nowhere in the United States is concern about the future supply of timber more accute than it is in the Pacific Northwest. Without capital gains, many wood lot owners will likely choose not to reforest their land. Resulting shortages of timber will undoubtedly translate into significantly greater pressure on public forest lands and mill closings in addition to those already predicted. In many of the small, rural communities I represent--where the local mill is the primary employer--its closure means more than the loss of jobs and a decreased tax base, it represents the extinction of a community. Capital gains treatment of timber, and its application to both individuals and corporations, has been proven capable of increasing the supply of timber.

Reinstatement of timber capital gains also makes good environmental sense. Good forestry and reforestation is vital for wildlife enhancement, water quality, aesthetics and recreation. Reforestation also plays a vital role in our efforts to combat the "greenhouse effect." Timber is the only natural resource which can be renewed within our lifespan--capital gains is a means for encouraging its continual renewal. At the same time, the land is growing the future supply of wood for jobs and America's homes.

Mr. Chairman, the Capital Investment Act of 1989 will provide the pool of venture capital necessary for developing new technology, creating new jobs, and enhancing our competitive position in the world's markets. In the same way that it will help rebuild stability in our financial markets--by encouraging long-term, productive investments as opposed to speculative, short-term investments--it will discourage the cut-and-run approach and encourage the nurturing of our nation's greatest natural resource.

Thank you, Mr. Chairman, for the opportunity to share my views with you on the issue of capital gains.

STATEMENT OF HON. SONNY CALLAHAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ALABAMA, AND COCHAIR, FORESTRY 2000 TASK FORCE

Mr. **CALLAHAN**. Thank you, Mr. Chairman. I, too, would echo the sentiments of my colleagues on the Forestry 2000 Task Force and tell you that, basically, I support the concept of the capital gains revisions that President Bush has submitted because I think it will stimulate our economy. I think that timber certainly ought to be included in that package. As a matter of fact, whether or not you pass the President's package, I think you ought to consider timber because timber was penalized so very greatly in the 1986 act Forty percent of basic rate of capital gains has, in some cases, actually tripled the tax that people have to pay for growing timber.

Timber is not a shopping center. Timber can't be depreciated. It appreciates, true. But over a 20-year period of time if, as the law now stands, you have to pay all of your expenses, nothing is deductible and in addition to that you don't get any capital gains reduction whatsoever.

So I'll submit to you my statement for the record and encourage you to take a close look at this problem. It impacts thousands of people in my State and in the United States of America. Contrary to what some people may believe, this is not something that's impacting the rich. In fact, in 1981 the Internal Revenue Service shows that the individual tax returns reporting timber sales, over 80 percent had adjusted gross income of less than $50,000. So that's very important for you to remember those thousands of landowners who need this help. We're depending upon you to assist us in that regard, and we appreciate this opportunity to address your committee this morning.

[The statement of Representative Callahan follows:]

STATEMENT OF
CONGRESSMAN SONNY CALLAHAN
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

APRIL 13, 1989

Thank you, Mr. Chairman.

Like my colleagues, I appreciate the opportunity to present this statement to the Ways and Means Committee. Your job is a difficult one; one which necessitates thoughtful deliberation on complex matters. Hopefully our collective statements today will help clarify certain issues coming before you, especially as they relate to timber.

Along with other members of the Forestry 2000 Task Force, I support the proposal to reestablish a capital gains differential and am encouraged by the President's initiative in this regard. It is obvious, however, that the President's proposal would be greatly improved if it could be correctly expanded to include corporate and individual timber holdings.

Capital gains has long served to promote greater savings and investment, and I believe our country is served well by public policies furthering those goals. While this Committee is to be greatly commended for its role in shaping the 1986 Tax Act, there were certain features which, when examined closely, have had a disastrous effect on timber growing activities. One of the more prominent of those features has been the loss of capital gains. The President's proposal to restore capital gains represents a step in the right direction, but its omission of timber is of great concern to the members of our Task Force.

While the 1986 Act's lower rates were instrumental in establishing much needed reform, the loss of capital gains dealt the timber industry a very serious blow. The rate differential for capital gains played a key role in the economics of growing timber. Now, without it, our private forest landowners face an uncertain future as they contemplate what should be done with their land. When combined with the unintended impact of the passive loss rules on timber growing activities, the loss of capital gains is driving many private landowners to the very brink of economic survival. Many of my constituents are uncertain if they can afford to manage the land properly and don't know if they will even reforest their property if they are close to harvest.

Mr. Chairman, perhaps a few observations on timber growing might be in order:

1. Timber takes a long time to grow -- locking in critical investment. What other industry takes 20 to 75 years to get any return on its initial investment?

2. Timber growing economics are tough, requiring three things: heavy front end investment, substantial carrying costs, and willingness to be locked in during the growth cycle.

3. Timber is susceptible to many natural hazards, with high risk from weather, disease, insects and fire -- in fact, you cannot get commercial insurance for these risks.

4. In spite of the high risks, the rate of return on timber is low -- maybe 4 per cent -- uninflated.

5. Perhaps contrary to what you may have read in the Washington papers, capital gains isn't just for the rich. In fact, 1981 Internal Revenue Service figures show that of the

individual tax returns reporting timber sales, over 80% had adjusted gross incomes of less than $50,000. There are thousands of landowners in my state of Alabama who don't consider themselves rich, but who relied steadily on capital gains.

Mr. Chairman, with all due respect for the outstanding work of this committee, the repeal of capital gains has been considered as a real breach of faith by the thousands of landowners whose investments have literally been locked into the ground during decades of high-risk growth.

The capital gains provision of the Tax Code has proven to be an effective long-term mechanism for increased timber production and improved forest management. Should President Bush's proposal to restore a capital gains differential be considered by this committee, it is my sincere hope that you will take into account the concerns of the Forestry 2000 Task Force regarding its application to timber.

Thank you again, Mr. Chairman, for allowing me to appear here today.

STATEMENT OF HON. ROBERT LINDSAY THOMAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, AND CO-CHAIR, FORESTRY 2000 TASK FORCE

Mr. LINDSAY THOMAS. Thank you, Mr. Chairman.

Mr. Chairman, if I might sort of wrap up here for the group by saying to you, I'm happy to be a certified tree farmer, a landowner myself. I've worked in the woodlands all of my life, and so I think I know the horse here. Let me just make a comment or two.

I've seen firsthand in my own State of Georgia, and I think the committee needs to know this, that we have lost 200,000 acres now being harvested each year that are not being replanted. As 200,000 acres more are being cut than are being reforested, I'm seeing firsthand the impact.

Mr. Chairman and members of the committee, there's no doubt but that thousands of timber growers planted trees decades ago with the confidence and the assurance that capital gains would be there when the time came to harvest. And now capital gains is gone and landowners have been left out in the cold. The rules were changed in the middle of the game with no opportunity for timber growers to react the way others could. Our trees are still in the ground. They can't be moved around and picked up and put in different places like stocks and bonds.

Mr. Chairman, the history of private forestry in the United States is directly related to the capital gains treatment of timber. This committee needs to know that prior to 1944 when the capital gains treatment of timber was first enacted, we were headed for a dramatic shortfall in timber production in this country. Since 1944 there's been a dramatic and a sustained increase in both harvest and reforestation.

As we know, growing trees is a long-term and risky enterprise and the whole value can be lost the very last year of the project, 15, 20, 25 years out. Most individuals cut a crop of trees only about once or twice in a lifetime. Moreover, without the capital gains differential future investments in growing trees will be highly unattractive resulting in a negative impact on jobs, as well as the future supply of wood.

You must remember that any loss of growth for trees cannot be recovered. You can't plant a tree retroactively. However, Mr. Chairman, there's another impact that concerns me greatly. It's one which has a profound effect, yet is not being recognized for the vital role it plays in our daily lives, and that is the impact of sound forestry management practices.

These practices serve to significantly enhance the overall environmental quality of our forest and their surrounding communities. Our professionally managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, and they provide for recreational needs and create monumental esthetic beauty for all of us. In fact, as you may already know, we are learning now the critical role being played by reforestation in efforts to combat the so-called greenhouse effect, a global phenomenon, while at the same time the land is growing trees for the future supply of wood.

Landowners are committed to sound environmental stewardship of our lands, proper care of the land has been instilled literally through generations and generations of timber ownership. However, Mr. Chairman, without the corresponding fair economic environment necessary to grow trees over the long run, represented in great part by capital gains, many landowners have reached the point in which their management practices will deteriorate even further and faster than their return on the investment.

I think it is a responsibility for us to note, that while we as American citizens are telling farmers in South America to stop cutting tropical rain forests we're at the same time, right here with our own United States Tax Code, forcing our own farmers and landowners without a fair, equitable, and stable economic environment to cut their land and over the long term, not reforest it to enhance all of the benefits that come from a well and proper managed forest enterprise.

Mr. Chairman, the committee thanks you for your consideration of our needs and we thank you for this opportunity to testify before you this morning.

[The statement of Mr. Thomas follows:]

STATEMENT OF

REP. LINDSAY THOMAS (D-GA)

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

REGARDING THE PROPOSAL CONTAINED IN
PRESIDENT BUSH'S BUDGET FOR FISCAL YEAR 1990
WITH RESPECT TO THE
CAPITAL GAINS RATE DEDUCTION FOR INDIVIDUALS

APRIL 13, 1989

Mr. Chairman, I speak to you today not only as an individual Member of Congress and a Co-Chairman of the "Forestry 2000 Task Force," but also as an individual certified tree farmer and landowner. I know first-hand from my own experience in growing trees the truly difficult circumstances now facing landowners in Georgia and all around the country.

While the overall lower rates of the 1986 tax bill may have been favorable to some, and your leadership in that effort is certainly to be commended, Mr. Chairman, most landowners have found that the loss of capital gains was a devastating blow, just now being felt. In fact, the loss of capital gains is literally draining the vitality of an entire industry in a way not fully contemplated when capital gains was repealed in 1986.

Thousands of timber growers planted trees decades ago with the confidence and assurance that capital gains would be there when the time came to harvest. Now capital gains is gone and landowners have been left out in the cold. The rules were changed in the middle of the game with no opportunity for timber growers to react the way others could. Our trees are still in the ground -- they can't be moved around like stocks and bonds.

In that regard, Mr. Chairman, I'm encouraged by the capital gains initiative in President Bush's budget proposal. From my own perspective as a tree farmer, I believe the initiative represents a recognition of the need to encourage long-term investment in vital resources.

However, President Bush's initiative also needs critically important modifications with respect to its application to timber growers. As you know, the proposal, with some exceptions, does not include what is known as Section 1231 timber, and does not include corporations. Only individuals who sell their land outright, or sell so-called investment timber would be eligible for the differential. Mr. Chairman, common sense alone, not to mention basic fairness and equity, calls for extending a capital gains differential to timber, as it has been for decades, and to provide that differential regardless of the form of ownership, corporate or individual.

Mr. Chairman, the history of private forestry in the United States is directly related to the capital gains treatment of timber. Prior to 1944, when the capital gains treatment of timber was first enacted, we were headed for a dramatic shortfall in timber production in this country. Since 1944, there has been a dramatic and sustained increase in both harvests and reforestation.

As we know, growing trees is a long-term and risky enterprise. Individual landowners who have cared for their forests for 25 to 75 years have suffered greatly with the loss of capital gains. Original investment decisions were based on capital gains treatment of this long-term income which occurs in many cases is only once or twice in a landowner's lifetime.

Moreover, without the capital gains differential, future investments in growing trees will be highly unattractive, resulting in a negative impact on jobs as well as future wood supply. You must remember that any loss of growth for trees can never be recovered -- you can't plant a tree retroactively.

However, Mr. Chairman, there is another impact which concerns me greatly, one which has a profound effect, and yet is only now being recognized for the vital role it plays in our daily lives -- that is the impact on sound forestry management practices. These practices serve to significantly enhance the overall environmental quality of our forests and their surrounding communities. Our professionally-managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs, and create monumental aesthetic beauty for all of us.

In fact, as you may already know, we are learning now the critical role being played by reforestation in efforts to combat the so-called "greenhouse effect," while at the same time the land is growing trees for the future supply of wood.

Landowners are committed to sound environmental stewardship of our forest land. Proper care of the land has been instilled literally through generations and generations of timber ownership. However, Mr. Chairman, many have reached the point that without the corresponding fair economic environment necessary to grow trees over the long run, represented in great part by capital gains, those management practices will deteriorate even faster than their return on investment.

We need to strengthen this nation's commitment to reforestation, not abandon the renewable resource of our forests. We are telling farmers in South America to stop cutting tropical rain forests, while at the same time, right here with our own U.S. Tax Code, we are forcing our farmers to stop reforestation. In my view, we need to provide our tree farmers and landowners with a fair, equitable, and stable economic environment, over the long term, which will enhance the productive use of our lands and the quality of our life.

Mr. Chairman, the "Forestry 2000 Task Force" respectfully seeks to convey a simple message to this Committee. Should a capital gains provision be considered by this Committee, fairness demands that its application extend to timber income and to both individual and corporate forms of ownership. The restoration of the capital gains structure is essential if timber growers are to meet raw material demands for the thousands of consumer products dependent upon wood and fiber. The need for a fair economic environment for timber growing is greater now than ever.

Thank you for the opportunity to present these comments today, and on behalf of the "Forestry 2000 Task Force" we hope that you will take our collective comments into account as you consider these important issues in the Ways and Means Committee.

Chairman **Rostenkowski**. Well, I want to thank you. I know how busy you gentlemen are, especially making this extra effort. I certainly appreciate your concern and what you've contributed to the committee. I'm sure that my colleagues share my view.

If there are any questions of any—Mr. Archer?

Mr. **Archer**. Mr. Chairman, I will be brief. I want to thank you for your testimony, too. I think it's very well taken and we could explore in detail a lot more reasons and justification for providing timber with capital gains treatment. I would like to ask Congressman Wyden, if I could, one question.

We had a witness before our committee, Mr. McIntyre, who represented the Citizens for Tax Justice who said that any preferential treatment for capital gains was a tax shelter and there was no way that you could prevent any preferential treatment for capital gains from being a tax shelter.

I just would like you to comment, if you would, Congressman Wyden.

Mr. **Wyden**. Well, I just disagree very strongly with that view. It just seems to me to be particularly inequitable to people who made investments in tree planting years ago with the expectation of lower capital gains rate and then they're immediately getting an increase. And now, as my colleagues have been talking about, they see tax bills double and triple. These are small woodlot owners. These are not fat cat kind of people sitting in fancy offices in metropolitan areas. These are hands-on small woodlot operators who work from morning until night. They're small—4 million of them in this country. These are not people who are passively trying to take a tax break, they are, as my colleague from Georgia mentioned, people who are, on an ongoing basis, engaged in responsible forestry management. They're concerned about conservation. They're also concerned about making a living. I think it greater distorts what those 4 million small woodlot operators do in this country to say that they are somehow the recipients of tax shelters and people who are ripping off the system.

Mr. **Archer**. So you would strongly say to this committee that a preferential rate for capital gains is not, per se, a tax shelter?

Mr. **Wyden**. Absolutely. You know, it's been my view that this committee has the kind of expertise so that it can identify people who really are trying to take advantage of the system and getting inequitable tax shelters. Let's target them rather than the 4 million small woodlot owners who we can see are engaging in hands-on responsible timber management, are trying to replant, look for the long term and who in no way, shape or form, resemble the recipients of passive shelters.

Mr. **Archer**. Thank you very much.

Mr. **Pease**. Would the gentleman yield? Thank you.

I'm interested in this line of questioning because, like other members of the committee, I was involved with the Tax Reform Act of 1986 and, of course, we were very concerned about tax shelters and tax loopholes. I can certainly appreciate that the constituents of you gentlemen are, as Ron says, largely small operators. You call them woodlots? I don't have them in my district. At any rate, they are small businessmen.

In terms of what Mr. McIntyre said yesterday, I'm just wondering about whether you can envision someone setting up a limited partnership made up of people who are in the top income tax bracket for the purpose of buying wood lots and trees and converting what would be their ordinary income for them into a capital gain.

First, can you envision that happening? Second, are you aware that it did occur prior to 1986?

Mr. LINDSAY THOMAS. Mr. Pease, I respond to you on that. And certainly my colleagues might want to illuminate on it. But to start with, our own effort and interest is to get at the real meat here, and that is to help individuals reforest their lands. That's what we're after.

You've got to keep in mind that the timber practice, even in the fastest growing areas where we can produce a tree, for example in my State, in 15 to 20 years, it is still a 15- to 20-year practice. And if you look at the returns, we're talking somewhere at a maximum of around 10 percent and the lowest of 5. Now, that doesn't attract many tax shelter oriented people, in my opinion. There is no way to insure your investment. And, in fact, it can be lost to fire or disease in the last stages of the project.

So I just don't think that any way that timber qualifies as a type of tax shelter or that capital gains could be construed as such. But some of my colleagues might want to comment. Just keep in mind that 64 percent, for example, in my own State and I think it's pretty much true in all the Southeastern States, are owned, again, by individuals. We're not talking about something here. But I just don't see this. I think you would find that if this was ever done, it was in a very low percentage and, perhaps, that could even be taken care of with perfection in any case if the legislation is passed.

Some of my colleagues might want to make a further point on that, but I just don't agree with that philosophy.

Mr. PEASE. I appreciate your comment.

Mr. CALLAHAN. Mr. Pease, I disagree, too. I don't know what difference it would make. You couldn't have a tax shelter if it only related to cut timber. We're not talking about a tax shelter capability, but whether it was a group of people who got together and formed some type of subchapter S or whatever, it still would only relate to cut timber. So there could be no shelter there. I can't envision how they could even see that a shelter could be formed.

Mr. PEASE. OK, I appreciate that. I can't, off-hand, envision it either. But we've had a lot of experience on this committee with high-priced lawyers and C.P.A.'s who could figure out ways to take advantage of most any provision that we have.

I gather from what you said, Mr. Thomas, that in principle, at least, if we were to move in this direction you would not have any objection to limiting it to individual owners rather than allowing corporations or partnerships?

Mr. LINDSAY THOMAS. I think small business should be included in this. Personally, I think we ought to tread very carefully because, again, we want to go back to the incentive of getting our lands reforested.

Let me add one thing, Mr. Pease. Sure, the advantage of the capital gains as far as the monetary advantage would go to the person owning and cutting the land. But please keep in mind what I've pointed out to you, that the forest lands of this country are essential and vital to everyone of us. They purify the air that every American breathes. They hold the soil together that our Nation depends upon. They put products on the export markets that we need in the balance of trade that generate thousands of jobs out there in the community. For example, in Georgia we have about 80,000 jobs generated from timber and 34,000 of those are in the city of Atlanta.

I hope you will keep in mind that this is an incentive to a natural resource that we all benefit from. I think when you look at it in that respect, it really makes more plausible the issue that we are discussing here.

Mr. **Wyden**. If I could just add one point very briefly. A lot of these are family corporations, chapter S corporations. So again we're talking about those 4 million small woodlot owners/family corporations.

Mr. **Pease**. OK. Well, I must say Mr. Thomas makes a very convincing case for the importance of trees and forests to our economy. I appreciate very much that enlightenment.

Mr. **Morrison**. Mr. Pease, if I could add just one other word. We grow real trees in the West. It takes 60 to 80 to 100 years. I think that underscores the importance of the really long-term investment. I think the structure from the taxpayer's point of view is less important than the incentive to get these trees growing for the sake of the future of the country.

Mr. **Pease**. I don't suppose it would be fair of us to open up the possibility of making a distinction between real trees and whatever the other kind are?

Mr. **Morrison**. Well, it might restart the Civil War, Mr. Pease. We'd rather not do that.

Mr. **Pease**. We would not want to do that.

Thank you very much.

Mr. **Morrison**. Thank you.

Chairman **Rostenkowski**. Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman. Very briefly, I would like to thank the panel for their very cogent testimony. It was very meaningful.

I don't see a great deal of possibility for using a dramatic tax shelter when our highest tax bracket now is 28 percent. I do not know how we can create something so that the high income people can shelter a great deal of income through creating an incentive for reforestation which, in effect, is what you are talking about. In the Northwest, when you are talking about a 50- or 60-year period, the decision has to be made now on whether we are going to reforest.

Mr. Thomas makes the point extremely well that it is in the Nation's best interest for us to create an incentive for reforestation.

I just want to thank you and I think Mr. Thomas' statement that you cannot plant a tree retroactively is a very important point. Once it is done, once that decision is made, it is gone. I think it is in our national interest to create, if necessary, an incentive and you'll have my support if we can get that far.

Mr. MORRISON. Thank you.

Mr. JENKINS. Mr. Chairman.

Chairman ROSTENKOWSKI. I want you gentlemen to understand that he hasn't changed his position in 10 years.

Mr. Jenkins.

Mr. JENKINS. Mr. Chairman, I simply want to express my appreciation to my colleague from Georgia, Mr. Lindsay Thomas and all of the other members of the panel for their testimony. I fully agree that if we're going to have a capital gains differential, certainly timber ought to be included. I have never understood why you would say that you could buy stock, a share of stock, and hold it for 12 months and get a differential, but if you plant a tree and hold it for 50 years or 40 years and sell it, you don't get a differential. That has never made good sense to me and I want to thank each of you for your testimony and for your leadership in this role.

Thank you very much.

Chairman ROSTENKOWSKI. Thank you very much, gentlemen, for joining us.

Mr. MORRISON. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Bonnie Titcomb, Richard Seward, Harold Schaitberger, Melodee Ault, William Flaherty, welcome to the committee, ladies and gentlemen. You have been instructed as to what your time allocations are. We're going to try and keep you within the framework of those times. You'll see those lights go on. If, however, you're going to run over a minute or so, we don't have a big problem with that. We don't want you to get nervous, particularly when the red light goes on.

By the same token, if you have a statement that you'd like us to insert in the record in its entirety, we will do that and if you'd like to summarize, it's entirely up to you. But if you'd like your whole statement to be included in the record, that will be done.

Let's see whose first here. Bonnie Titcomb, if you'll begin your testimony, the committee is ready. Do you each understand the way we do this? You each get your allocation of time. You make your statement and then the committee will interrogate you.

STATEMENT OF STATE SENATOR BONNIE L. TITCOMB, CHAIRMAN OF THE AGING, RETIREMENT AND VETERANS COMMITTEE, MAINE STATE SENATE, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Ms. TITCOMB. Mr. Chairman and members of the committee my name is Bonnie Titcomb. I'm chairperson of the Aging, Retirement and Veterans Committee of the Maine State Senate and I'm speaking on behalf of the National Conference of State Legislatures, NCSL.

NCSL is a nonpartisan organization created to serve the legislators and staffs of the Nation's 50 States, its commonwealths and territories.

I thank you for this opportunity to testify on the revenue proposals presented in the President's budget. I especially would like to voice our opposition to the President's proposal to extend the Medicare payroll tax to State and local government employees.

We in the Nation's State legislatures understand the urgent need to address the Federal budget deficit, and we support your responsible efforts to do so. We know that several of the President's proposals will have a significant fiscal impact on the States. Of the $10.6 billion additional revenue in the President's budget, we urge you to reject any measures that would disrupt intergovernmental fiscal relations and impair the ability of State Governments to meet their responsibilities to our shared constituencies. Eliminating the deficit is important to all of us, but shifting the fiscal problems from one level of government to another is not the solution.

Throughout the decade, States have been called upon to assume increasing responsibility in the provision of vital public services to the people. We have accepted this fiscal responsibility even though Federal actions have curbed the ability of States to adequately finance their activities. At the same time, the misconception has arisen to the effect that the fiscal condition of the States is so strong that States can be expected to shoulder a disproportionate share of the burden of Federal deficit reduction without adversely affecting their services. In reality, the fiscal condition of the States has declined over the years to the point that the average State budget surplus is only 2.7 percent. Because we do have the option of enacting monetary policy and we are constrained by our constitutions, we must maintain a balanced budget.

An example of shifting the burden to the States is the agreement made between the Federal and State Governments in the 1985 Consolidated Omnibus Budget Reconciliation Act, COBRA. In response to the Federal Government's pressing need for revenues, Congress enacted COBRA which requires public employers to phase-in Medicare hospital insurance coverage for all State and local government employees hired after April 1, 1986. Through adoption of the phase-in provision, which will result in Medicare coverage of all public employees through normal job attrition, Congress assured itself that all public employees will ultimately pay the full Medicare tax to the Federal Government. Similarly, the phase-in provision allowed State and local governments time to adjust their budgets for this additional tax.

However, in order to offset the budget deficit, the administration now proposes to impose mandatory Medicare coverage for all State and local government employees notwithstanding the phase-in agreement. This is clearly a violation of a commitment made by the Federal Government to gradually phase-in the Medicare payroll tax. This proposal is advanced by President Bush's budget document, which endorses President Reagan's proposal of the last several years; a proposal which this committee has rejected several times.

The change in coverage, proposed to be effective October 1, 1989, is estimated to increase receipts to the hospital insurance trust fund by $1.8 billion in fiscal year 1990. This represents a direct transfer from the States which they have to pay. Furthermore, through collective bargaining many States may end up paying the employee's portion of the tax. Financially, the proposed extension would add an immediate expense to State budgets ranging from an estimated $300 thousand to $270 million annually. In my State of Maine, the fiscal impact would be over $14 million for fiscal year 1990. Although Maine has experienced a favorable fiscal climate, our surplus situation is surely misleading. Much of the surplus is due to inaccurate revenue projections by the administration. However, the legislature is addressing this overcollection problem, which will eliminate any future surpluses. With erratic revenue projections and the conflict between the legislature and the administration, Maine needs every dollar to which it is entitled. The extension of the Medicare payroll tax will be one more fiscal burden that will aggravate our budget process and will strain our ability to provide services to the public.

This additional tax on public employees and employers would especially threaten the fiscal health of at least 10 States. These States are: California, Colorado, Florida, Illinois, Louisiana, Massachusetts, Minnesota, New York, Ohio, and Texas. While the impact of the proposal would fall most heavily upon governments in these 10 States, 49 States have some noncovered employees which would impact their operating budgets as well.

Moreover, the extension of the Medicare payroll tax will affect our constituencies. Despite the promise of the President not to raise taxes and the efforts of Congress to provide tax relief to lower- and middle-income individuals, this proposal targets 4 to 5 million lower- and middle-income Americans and their spouses for a tax increase that would more than offset the tax cut they received from the Tax Reform Act of 1986. According to the Joint Committee on Taxation, the Tax Reform Act provided taxpayers with incomes in the range of $20,000 to $30,000 with an average tax cut of $220. This new Medicare tax that would be imposed upon State and local government employees equaling $1.45 percent of payroll. For example, the average Illinois teacher makes $25,454 annually. The new tax of $369 would more than offset the $281 provided through tax relief. The attached tables, which I have sent with this testimony, estimate the cost of extended coverage on a State-by-State basis.

Mandatory Medicare coverage cannot be justified on the ground that it would benefit the affected employees. Since the passage of COBRA, local jurisdictions have had the option of joining the Medicare system without also participating in the Social Security system. If such Medicare coverage were desirable, employees would pressure their employers to adopt it; instead, they are actively resisting efforts to expand mandatory coverage. The consensus is that the overriding goal of insuring adequate health care for public employees in their retirement year is currently being met by many States.

Federal revenues raised by coverage of these new employees have already been collected by Congress under COBRA and are included in budget allocations. As a result of job attrition, which averages nine percent per year, the revenues in the out-years will decline substantially and ultimately will decline to zero. At best, the mandatory Medicare coverage proposal will provide only a quick fix to deficit reduction and will do nothing to reduce the structural deficit. Meanwhile, the States will be faced with immediate tax burden which many cannot afford.

We in State government stand ready to bare our fair share of the burden in the effort to reduce the Federal budget deficit. However, over the past decade, State and local governments have taken a disproportionate share of the Federal cutbacks and Federal mandates. An immediate extension of the Medicare payroll to all State and local government employees is clearly a Federal mandate that States should not have to bear. This proposal is an evident violation of the agreement made between the Federal and State Governments in COBRA to phase in the government employees over the next few years. Bearing in mind the fiscal condition of the States and the agreement made under COBRA, we ask you to reject the President's Medicare payroll tax proposal.

Mr. Chairman and members of the committee, thank you for including the National Conference of State Legislatures in your hearing schedule and giving me the opportunity to testify to you today.

[Attachments to Senator Titcomb's statement follow:]

ANNUAL COST TO STATE AND LOCAL GOVERNMENTS
OF MEDICARE COVERAGE OF ALL EMPLOYEES
(in millions of dollars) 1/

State	Number of Public Employees Who Are Not Covered by the Social Security System 1/	Number of Public Employees who are not covered by the Medicare system 2/	Percentage of Public Employees Not Covered by Medicare 3/	Cost of Medicare Coverage of All State and Local Employees 4/
Alabama	27,000	22,140	9.0	7.4
Alaska	40,000	32,800	58.6	10.9
Arizona	21,000	17,220	9.0	5.7
Arkansas	39,000	31,980	10.7	10.7
California	991,000	812,620	51.7	271.0
Colorado	150,000	123,000	62.3	41.0
Connecticut	63,000	51,660	30.2	17.2
Delaware	14,000	11,480	27.9	3.9
Florida	127,000	104,140	17.2	34.7
Georgia	64,000	52,480	14.8	17.5
Hawaii	24,000	19,680	27.1	6.6
Idaho	0	0	0	0
Illinois	299,000	245,180	39.4	81.0
Indiana	54,000	44,280	13.9	14.8
Iowa	5,000	4,100	1.6	1.4
Kansas	2,000	1,640	.8	.6
Kentucky	56,000	45,920	22.1	15.3
Louisiana	271,000	222,220	69.7	74.1
Maine	52,000	42,640	50.2	14.2
Maryland	29,000	23,780	8.2	8.0
Massachusetts	334,000	273,880	62.0	91.3
Michigan	19,000	15,580	3.3	5.2
Minnesota	96,000	78,720	37.1	26.2
Mississippi	2,000	1,640	.8	.6
Missouri	62,000	50,840	18.0	17.0
Montana	5,000	4,100	7.4	1.4
Nebraska	2,000	1,640	1.6	.6
Nevada	49,000	40,180	77.1	13.4
New Hampshire	6,000	4,920	8.2	1.6

ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYEES
OF MEDICARE COVERAGE OF ALL EMPLOYEES

State	Annual salary of average public Employee 1/	Annual tax increase resulting from proposal 2/	Average tax decrease resulting from the Tax Reform Act 3/
Alabama	$19,272	$279	$200
Alaska	39,084	567	273
Arizona	24,996	362	220
Arkansas	17,796	258	200
California	30,084	436	273
Colorado	23,676	343	220
Connecticut	24,360	353	220
Delaware	22,884	332	220
Dist. of Columbia	33,288	483	273
Florida	20,556	298	220
Georgia	19,056	276	200
Hawaii	22,596	328	220
Idaho	18,852	273	200
Illinois	24,708	358	220
Indiana	22,500	327	220
Iowa	21,024	305	220
Kansas	20,124	292	220
Kentucky	19,248	279	200
Louisiana	19,080	277	200
Maine	18,404	267	200
Maryland	27,144	394	220
Massachusetts	23,976	348	220
Michigan	26,808	389	220
Minnesota	25,296	367	220
Mississippi	16,116	234	200
Missouri	20,244	294	220
Montana	22,284	323	220

New Jersey	30,000	24,600	4.9	8.2
New Mexico	33,000	27,060	22.1	9.0
New York	153,000	125,460	9.8	41.8
North Carolina	43,000	35,260	9.0	11.7
North Dakota	6,000	4,920	3.2	1.6
Ohio	595,000	487,900	82.0	164.1
Oklahoma	33,000	27,060	12.3	9.0
Oregon	14,000	11,480	5.7	3.9
Pennsylvania	36,000	29,520	4.9	9.8
Rhode Island	25,000	20,500	35.3	6.8
South Carolina	6,000	4,920	2.5	1.6
South Dakota	2,000	1,640	4.1	.6
Tennessee	29,000	23,780	9.8	8.0
Texas	406,000	308,320	41.0	132.8
Utah	1,000	820	.8	.2
Vermont	1,000	820	1.6	.2
Virginia	73,000	59,860	14.8	19.7
Washington	36,000	29,520	10.7	9.8
West Virginia	7,000	5,740	4.9	1.9
Wisconsin	48,000	39,360	13.1	13.1
Wyoming	5,000	4,100	8.2	1.4
TOTAL	4,346,000	3,727,730		$1,249.3

1/ These figures reflect only the 1.45% that must be paid by the governments as employers, and do not include the cost increases to their employees, who must also begin to pay the 1.45% Medicare tax. (See reverse side for increased tax burden on individual employees.)

2/ Social Security Administration, 1985 Current Population Survey and Continuous Work History Sample as reprinted in Congressional Research Service paper "Medicare Coverage of Employees of State and Local Government," prepared at the request of the Subcommittee on Health of the House Committee on Ways and Means by David Koitz, Specialist in Social Legislation, Education and Public Welfare Division (March 11, 1987).

3 The Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, requires public employees hired after March 31, 1986 to participate in the Medicare system. Because employee turnover occurs at a rate of approximately 5% per year, in the two years since COBRA took effect, approximately 10% of previously non-covered public employees are now covered by Medicare. The number of public employees covered by Social Security has therefore been reduced by 10% to reflect the number of employees who are not now covered by Medicare.

4/ Given that the employer's part of the 1987 Medicare tax is 1.45%, and assuming that the salary of the average state or local government employee is $23,000, each governmental employer's cost is equal to the number of employees, multiplied by 23,000, multiplied by 1.45%.

Nebraska	18,560	270	230
Nevada	23,676	343	220
New Hampshire	19,300	280	280
New Jersey	24,192	351	220
New Mexico	19,680	285	290
New York	26,220	380	220
North Carolina	19,984	290	290
North Dakota	21,984	319	220
Ohio	21,492	312	220
Oklahoma	18,816	273	280
Oregon	22,632	328	220
Pennsylvania	22,068	320	220
Rhode Island	24,204	351	220
South Carolina	16,780	243	280
South Dakota	17,232	250	280
Tennessee	18,580	270	280
Texas	20,676	300	220
Utah	21,528	312	220
Vermont	19,248	279	190
Virginia	20,652	299	220
Washington	24,504	355	220
West Virginia	17,940	260	280
Wisconsin	23,148	336	220
Wyoming	23,404	339	220

1/ U.S. Bureau of the Census, Public Employment in 1985 - Government Employment (Series GE85-No.1) at 8.

2/ The amount of the new Medicare tax is derived by multiplying the average employee's salary by 1.45%.

3/ Joint Committee on Taxation Staff, Data on Distribution by Income Class of Effects of H.R. 3838, Tax Reform Act of 1986 (JCS - 28-86) (October 1, 1986), Table 4.

Chairman Rostenkowski. Thank you very much.

Mr. Seward.

STATEMENT OF RICHARD SEWARD, AND PAUL CARLSON, BARGAINING AND STEERING COMMITTEE MEMBER, ALASKA STATE EMPLOYEES ASSOCIATION [ASEA] OF THE AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES, AFL-CIO

Mr. Seward. Good morning, Mr. Chairman. I'm Richard Seward with the Alaska State Employees Association [ASEA]. With me today is Paul Carlson, also of ASEA. We're here on behalf of the 1.2 million members of the American Federation of State, County and Municipal Employees known as AFSCME.

I am here to strongly oppose the administration's proposal to extend the Medicare tax to State and local employees not currently covered by the system.

The Congressional Budget Office projects that requiring 100 percent coverage of all State and local government employees for Medicare would generate $9 to $10 billion in new tax revenues for the Federal Government over the next 5 years, an average of $2 billion a year. While this tax increase is seen as a means of lowering the Federal deficit, it ignores the fact that it would increase the deficits of State and local governments, which will be required to pay for half of the new taxes.

Fiscally distressed States would be hit the hardest by this proposal. In 1988, the Congressional Research Service estimated the annual cost to States of providing coverage at $1 billion. However, this annual burden will not be borne equally by all States. In fact, while most every State will feel some impact, it is largely those States such as my own State of Alaska with Louisiana, Massachusetts, California, New York, and Texas that must come up with the majority of that $1 billion. It's estimated that these six States alone would be funding over $600 million a year of that $1 billion helping the Federal deficit while hurting their own.

The States I've just mentioned are exactly those States which are currently facing severe budget crisis. New York faces a deficit next year of $2.6 billion. This new tax, would cost New York $42 million a year. California already covers over half their employees on Medicare and faces a $500 million deficit each year. This new tax would cost $271 million. Massachusetts with a $750 million deficit, adds $91 million with this new tax. Louisiana and Alaska are facing billions of dollars in deficit and are really distressed States. Their unemployment rate is twice the national average.

In my home State of Alaska, layoff notices are going out this week to State employees. We're trying to come up with money to deal with the oilspill, the employees have had no raise in over 4 years and at the same time the administration is proposing a new tax on our employees.

All across the country the employees of these State and local governments are already being asked to make concessions in their benefits plans and their wages are being reduced. Adding this additional tax to their already meager income levels would be harsh and could place many of these workers at financial risk. Selectively choosing State and local government employees to be the only Americans to shoulder a significant tax increase is asking our public servants to pay for a deficit they did not create nor from which they have benefited.

Moreover, many, if not all of these State and local workers have planned and paid for retirement health insurance protection through their own State and local systems. Medicare coverage would result in considerable duplication of benefits and expense.

There are some who have a concern that a significant segment of State and local government employees are not covered by Medicare, and yet may receive benefits in the future. This problem has already been addressed. With the passage of the Consolidated Omnibus Budget Reconciliation Act of 1985 all new hires after April 1, 1986, will be automatically covered by Medicare. Eventually all State and local government employees will be paying the Medicare tax. The Social Security Administration projects 50 percent of the noncovered segment in the State and local workers will be brought into Medicare by 1993, just 7 years after the enactment of the law.

In our opinion, this proposal is not an attempt to deal with the issues of noncovered workers or workers not contributing to the system. It is purely and simply deficit reduction. Members of my union have heard the President say "read my lips, no new taxes." We see this as a new tax.

Mr. Chairman, distinguished members of the committee, it's been a pleasure to present my views this morning. I'd be happy to answer any questions.

Chairman ROSTENKOWSKI. Thank you, Mr. Seward.

[The statement of Mr. Seward follows:]

TESTIMONY OF RICHARD SEWARD
BARGAINING AND STEERING COMMITTEE MEMBER
ALASKA STATE EMPLOYEES ASSOCIATION (ASEA) OF THE
AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES

Good morning, Mr. Chairman, I am Richard Seward, Bargaining and Steering Committee member of the Alaska State Employees Association (ASAE). With me today is Paul Carlson, also of ASAE. My testimony is given on behalf of the 1.2 million members of the American Federation of State, County and Municipal Employees (AFSCME). We greatly appreciate the opportunity to testify this morning. I am here to strongly oppose the Administration's proposal to extend the Medicare tax to state and local employees not currently covered by the system.

The Congressional Budget Office (CBO) projects that requiring 100% coverage of all state and local government employees for Medicare would generate $9 to $10 billion in new tax revenues for the Federal government over the next five years, averaging $2 billion a year. While this tax increase is seen as a means of lowering the federal deficit, it ignores the fact that it would increase the deficits of state and local governments, which will be required to pay for half of the new taxes.

Fiscally distressed states would be hit the hardest by this proposal. In 1988, the Congressional Research Service (CRS) estimated the annual cost to states of providing coverage at $1 billion. However, this annual burden will not be borne evenly by all states. In, fact, while most every state will feel some impact, it is largely those states - such as my own State of Alaska - Louisiana, Massachusetts, California, New York and Texas, that must come up with the majority of that $1 billion. It is estimated that these six states alone would be funding over $600 million a year of that $1 billion - helping the federal deficit while hurting their own.

The states which I just mentioned are exactly those states which are currently facing a severe budget crisis. It would be a substantial burden for those states that do not know how they are going to pay current service budgets for this year, let alone for the next five years.

The resource drain of Medicare coverage on the state and local governments of New York, a state that is grappling with a $2.6 billion current services deficit for the next year, is estimated at $42 million dollars per year. California, which currently covers about half of its state and local governments with Medicare, would have to come up with an additional $271 million per year to cover them all. This is expected from a state that is estimating a $500 million dollar deficit next year. Similarly, Massachusetts, which is facing a $750 million state deficit, would be forced to raise an additional $91 million to meet the requirements of this proposal.

I have not even mentioned the disaster consequences of this tax on severely depressed states, such as Louisiana and my own state of Alaska, which are estimating deficits in the billions of dollars, and have unemployment rates twice as high as the national average. Louisiana alone would have to pay $75 million annually, and Alaska $10 million, new costs we can hardly afford.

All across the country, the employees of these state and local governments are already being asked to make concessions in their benefit plans and their wages are being reduced. Adding this additional tax to their already meager income levels would be harsh and could place many of these workers at financial risk. Selectively choosing state and local government employees to be the only Americans to shoulder a significant tax increase is asking our public servants to pay for a deficit they did not create nor from which they have benefitted. This President keeps telling us to read his lips - no new taxes. I bet these workers don't know that the President isn't talking about them!

Moreover, many, if not all of these state and local workers have planned and paid for retirement health insurance protection through their own state or local systems. Medicare coverage would result in considerable duplication of benefits and expense.

There are some who have a concern that a significant segment of state and local government employees are not covered by Medicare, and yet may receive benefits in the future. This problem has already been addressed. With the passage of the Consolidated Omnibus Reconciliation Act of 1985 (COBRA), all new hires after April 1, 1986 will be automatically covered by Medicare. Eventually all state and local government employees will be paying the Medicare tax. The Social Security Administration (SSA) projects that 50% of the noncovered segment of state and local workers will be brought under Medicare by 1993, just seven years after enactment of the law. In our opinion, this proposal is not an attempt to deal with the issues of uncovered workers or workers not contributing to the system. It is purely and simply deficit reduction.

Mr. Chairman and distinguished members of the Committee, it has been a pleasure to present my views this morning. I would be happy to answer any questions you may have.

STATEMNENT OF HAROLD A. SCHAITBERGER, EXECUTIVE ASSISTANT TO THE PRESIDENT, INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS, AFL-CIO

Mr. SCHAITBERGER. Thank you, Mr. Chairman. Good morning.

My name is Harold Schaitberger, and I'm the executive assistant to the president of the International Association of Fire Fighters, AFL-CIO. The IAFF represents 177,000 professional firefighters in the United States and Canada. I am pleased to appear today to testify in opposition to the administration's fiscal year 1990 budget proposal to extend the Medicare tax to currently noncovered employees of State and municipal governments.

I find it ironic, and disappointing, that this proposal was advanced by the no new taxes President only a few short weeks after taking office. President Bush may call the proposal a revenue enhancer, or any number of convenient terms, but the fact remains that the proposal is nothing more than a new tax on middle-income public employees.

I, and the members of the IAFF are sympathetic to the urgent need to reduce the Federal budget deficit. However, the public employees of this country have done their part and cannot be expected to shoulder greater burdens for the cause of deficit reduction. The average professional firefighter supports a family on $18,500 per year. These members simply cannot afford the additional tax.

Make no mistake, this proposal has been advanced repeatedly as a revenue enhancer and not, as some would have us believe, because it is fair or equitable to expand coverage. Proponents claim that it would be equitable to extend the tax to noncovered employees of State and municipal governments. They are dead wrong. The equities are on our side.

Before I address the fallacies of the equity arguments, I want to point out that the proposal is overrated as a revenue enhancer. As a result of the 1985 COBRA law, the Medicare tax was imposed on new hires of State and municipal governments effective April 1, 1986. Due to attrition rates of approximately 9 to 10 percent per year, the potential revenue effect continues to dwindle rapidly and will have no net effect on revenue by approximately 1996. A permanent solution to the deficit problem requires substantial sources of continuing revenue. This particular revenue option does not fit that criterion because the net revenue effect will decline to zero in a relatively short period of time. At the point of diminished returns, Congress will be under new pressures to find additional sources of revenue. Long after the revenue effect diminishes to zero, public employees and retirees will be paying the cost, in higher taxes and disruption of their retirement health plans.

State and municipal governments will also shoulder a disproportionately large share of the burden of deficit reduction, since for the past 8 years they have suffered under a barrage of cuts in Federal aid programs. Additional financial burdens on State and municipal governments will lead to a reduction in essential police and fire services, at a time when municipalities are struggling to maintain current levels of service. The citizens of this country need more police and fire protection, not less.

On the issue of equity, proponents have often claimed that expansion of the tax is fair because a majority of State and municipal employees receive Medicare benefits having paid little or nothing into the system. The implication of the argument is that State and municipal government employees have been receiving a free ride with respect to Medicare benefits. Our members, who work in one of the most hazardous occupations, do not receive a free ride with respect to any retirement health benefits.

The free ride argument is misleading when you consider that State and municipal employees who are entitled to receive Medicare benefits become eligible by precisely the same eligibility rules that apply to every other citizen in this country—by working the required number of quarters in covered employment or as a result of their spouse's covered employment.

To the extent that the perceived inequity regarding Medicare eligibility of State and municipal employees actually exists, it was corrected by a provision in the 1985 COBRA law to extend coverage to all State and municipal employees hired after April 1, 1986. This provision represented a compromise between the proponents and opponents of full and immediate coverage. The compromise provision allows for a gradual transition toward full coverage, while grandfathering employees who are already working as of that date and who have a vested interest in their independent retirement and health plans. When we talk about equities, we must not forget the compromise agreement implemented by Congress in 1985.

Perhaps most seriously is the detrimental impact the proposal will have on existing retirement and health plans. For years, Congress specifically excluded employees of State and municipal governments from coverage under Medicare. As a result, these employees and their employers have spent years building sound and secure health plans, many of which provide benefits superior to Medicare. Under most systems, employees must pay all or part of the premium for these benefits. Imposition of the Medicare tax will increase employee costs without adding new benefits.

In the public safety field, retirement and health plan benefits are structured to reflect the unique needs of employees in hazardous occupations, and often set an earlier retirement age than for most other occupations. Mandatory coverage is a disruption to these plans. In many cases, when full mandatory coverage is implemented, Medicare will become the primary provider at age 65, and the employee's retirement health plan becomes a secondary provider. The increased costs and burdensome administrative requirements of coverage under two systems drains resources from existing independent retirement health systems.

There is nothing equitable about disrupting and derailing the retirement health benefits of public safety employees for the cause of deficit reduction. Not only is it unfair, but it is unwise. Frequent changes in tax policy impede an important public policy goal—the development of independent retirement security programs.

I want to conclude my statement by urging the committee to approach the monstrous deficit problem by searching for substantial, real and continuing sources of new revenue. If new taxes are needed, they should be levied on individuals and businesses most able to pay and on those who have not done their fair share for the cause of deficit reduction.

The administration's proposal to expand the Medicare tax fails the fairness test and does not provide a continuing source of additional Federal revenue.

I'd like to thank Chairman Rostenkowski and the other members of the committee for the opportunity to testify. And if I may, Mr. Chairman, I have a statement from the National Conference on Public Employee Retirement Systems representing over 350 retirement plans and 6 million participants which, if permitted, I would like to at least submit to you and the committee for inclusion in the record.

[An attachment to the statement follows:]

Testimony of Ronald Usher, President
National Conference on Public Employee Retirement Systems
Re: FY 1990 Revenue Proposals
April 13, 1989

Mr. Chairman and distinguished members of the committee, my name is Ronald Usher, and I am President of the National Conference on Public

Employee Retirement Systems (NCPERS), a national retirement association comprised of over 350 state and local retirement plans representing over 6 million members and managing approximately $300 billion in assets.

We submit this statement to discuss a serious proposal which may be considered during your committee's actions on the fiscal 1990 budget. It should be stated at the outset that NCPERS is deeply concerned about the current federal deficit and supports the Congress in its attempt to reduce it.

During the last several budget cycles, proposals for extending medicare coverage to state and local government employees, currently excluded from coverage, has been offered in several forms.

NCPERS strongly opposes the mandatory inclusion of state and local government employees, who are not presently covered by the medicare program, into the system by the United States Congress.

It is important to note that NCPERS strongly supports the Social Security and Medicare programs. Approximately 75% of current state and local government employees are presently covered. The Congress has addressed the proposition of mandatory coverage several times over the last dozen years and each time, in its wisdom, has determined that such consideration was neither feasible nor appropriate. In economic terms the direct results of mandating Medicare coverage would be an increased tax burden for state and local governments and their employees. It would also have serious negative repercussions on the national economy. At the same time, mandated coverage would make no significant contribution to the Medicare program as a whole and may even create future financial problems.

It has been suggested that mandatory Medicare coverage would help in the reduction of the current federal deficit. In fact, it would lead to increased costs not only for governments at all levels but also for their employees. At best, it would provide a short term increase in federal revenues.

I would also like to remind you that the Congress extended Medicare coverage to newly hired state and local government workers effective in 1986. This compromise will allow a smooth and timely coverage for all workers in the not too distant future.

In previous Congresses, supporters of mandatory coverage often pointed to the abuses of the system by some as a justification for mandating coverage. However, Congressional action in 1981, 1983, and 1985 adequately addressed those concerns and eliminated perceived loopholes as they apply to public workers.

It appears to us that the Congress may unwisely look toward mandatory Medicare coverage as a method of generating short term revenues. We believe this conclusion is short sighted. Although mandating coverage would add funds to the system in the short run, in the long run it may increase liabilities when newly covered employees become eligible for benefits.

Mandating Medicare coverage will cause serious administrative regulatory and fiscal problems for local and state governments which will be required to develop new programs and pay new taxes. The liabilities for such a consideration far outweigh the assets.

Therefore, we ask that your committee reject any proposal for mandated coverage in the Medicare system for state and local government employees.

Chairman ROSTENKOWSKI. We'll make it part of the record. Thank you very much, Mr. Schaitberger.

Mr. SCHAITBERGER. Thank you.

Chairman ROSTENKOWSKI. Ms. Ault.

STATEMENT OF MELODEE AULT, PRESIDENT, LAS VEGAS POLICE PROTECTIVE ASSOCIATION CIVIL EMPLOYEES, INC.

Ms. AULT. Thank you. Mr. Chairman, distinguished members of the committee, my name is Melodee Ault, and I am the president of the Las Vegas Police Protective Association Civil Employees and I represent the noncommissioned members of the Las Vegas Metropolitan Police Department in Las Vegas, NV. I appreciate the opportunity to appear before you to voice our strong opposition to the proposed extension of mandatory Medicare to all public employees. These are not only the views of my members, but also those of nearly 8,000 other public employees in the southern Nevada area, including those of the Las Vegas City Employees Association, the Clark County Public Employees Association, and the Las Vegas Police.

Our views, however, are also the same as the 50,000 public employees in the State of Nevada and the millions of public employees across the country who will be adversely effected by the imposition of this new tax. I say "adversely," because not only will their paychecks go down, but in southern Nevada our salary and benefit packages are determined by collective bargaining and employers at the bargaining table might well insist that the quality of the employee's medical coverage be reduced or the cost to the employee increased in order to fund the increased burden of the new tax.

I don't know how many of you have been to southern Nevada, but we have a permanent resident population of 660,000 which swells dramatically each year as a result of conventions, the resort industry, and major sporting events. Over 16 million people visited southern Nevada last year and that means that at times as many 1½ million people, both residents and visitors, are being protected by our 1,800 member department. Not only are there many people to protect, but our over 7,800 square miles of jurisdictional area is larger than the States of Hawaii, Rhode Island, Delaware or New Jersey.

The average yearly salary for my members is $25,600 and 60 percent of my members make less and considerably less than that. These employees are not well positioned to shoulder the additional tax liability of $370 that the mandatory coverage proposal would require. To ask individuals who have chosen a career in public safety and/or public service to take a 1.45-percent cut in pay seems harsh and unfair, especially considering many of these professional people could have had better paying jobs in the private sector.

As for the Government's share, the liability for the Metropolitan Police Department would be $730,240 annually. Our department is currently operating with a 2-percent vacancy factor and were they to have to pay that amount in Medicare taxes, it could increase that vacancy factor by an additional 2 percent.

In point of fact, currently our department has 1.4 police officers per 1,000 residents. The national average for a city the size of Las Vegas is 2.7

That $730,000 plus share is equivalent to 23 police officers on the street.

As in much of the rest of the country, we're seeing an increase in gang and drug related activity necessitating the formation of special squads and details. If the mandatory coverage proposal were enacted, the department would lose the equivalent of three drug and gang task forces, making our streets less safe for our citizens and visitors.

Another illustration of the impact of the mandatory proposal I'd like to draw your attention to is the Communications Bureau, an area with which I'm quite familiar as I have been a communication specialist for 13 years. I and my coworkers are the voice at the other end of the line when you dial 911. And now, at anytime, it's possible that there are as few as seven operators responsible to the citizens of 7,800 square miles.

Quick response time can be the difference between life and death. Let me illustrate. Sometime ago we received a call from a young woman requesting the police because her mother was involved in a domestic dispute with her boyfriend. The man had burst through the front door with his gun in hand intending to kill the woman. Instead, he shot the daughter, who despite her wounds, was able to make her way to the bedroom to call us. As is customary, the dispatcher stayed on the phone with the young woman to provide support to her and to simultaneously relay information to officers and medics in route to the scene. While speaking to her, the dispatcher heard one gunshot ring out. This was the shot that killed her mother. When officers arrived seconds later, they found the man on his way down the hall to finish off the daughter. Shots were exchanged between officers and the suspect and he was killed. That young woman is alive today because someone was there to promptly answer that call to 911.

We in the West have a long standing tradition of taking care of our own. When Social Security was enacted, State and local government employees like me and my members weren't allowed to join. So we developed a State retirement system and health plans to take care of our own. Our members and retirees have excellent health benefits. Please don't jeopardize these benefits by making us pay for a tax we can't afford. Please don't interfere with our existing arrangement because it works for us.

On behalf of my members, I urge you to totally reject the extension of mandatory Medicare coverage to all State and local government employees once and for all.

Thank you for this opportunity to appear before the committee.

Chairman **Rostenkowski**. Thank you, Ms. Ault.

[The statement of Ms. Ault follows:]

Statement of Melodee Ault
on behalf of
Las Vegas Police Protective Association
Civil Employees, Inc.
in Opposition to Mandatory Medicare Coverage
of State and Local Government Employees

Mr. Chairman, distinguished members of the Committee, my name is Melodee Ault, and I am the President of the Las Vegas Police Protective Association Civil Employees, Inc. representing the 600 non-commissioned members of the Las Vegas Metropolitan Police Department in Las Vegas, Nevada. I appreciate this opportunity to appear before you to voice our opposition to the proposed extension of mandatory Medicare to all public employees. The views I am expressing to you are those of nearly 8,000 public employees in Southern Nevada, including those of the Las Vegas City Employees Association and its 2,000 public employees, the Clark County Public Employees Association representing 4,000 public employees, and the Las Vegas Police Protective Association Metro which represents 1,200 police and corrections officers.

There are approximately 50,000 public employees in the State of Nevada who will be adversely affected by imposition of this new tax. I say adversely because not only would their pay checks go down, but their medical coverage could conceivably decrease as their employer would be required to fund the increased burden of the new tax.

The Metropolitan Police Department is funded by the governments of the City of Las Vegas and Clark County. This is over 7,800 square miles of jurisdictional area and larger than the states of Hawaii, Rhode Island, Delaware, and New Jersey.

We have a permanent population of 660,000, which is dramatically increased by the number of visitors each year. For example, over 16 million people visited Southern Nevada last year. That means that, at times, as many as 1,500,000 residents, both permanent and transient, are being protected by our small, 1,800 member Department.

My members are communications dispatchers, helicopter mechanics, abuse and neglect specialists, account clerks, criminalistics field officers, chemists, electronics maintenance technicians, airport security officers, clerical staff, and other support personnel. The average yearly salary for these employees is $25,600. These employees' additional tax liability would average $370.00. The average yearly salary for commissioned personnel (police and corrections) is $32,000. The additional tax liability for these employees would be an average of $464.00. To ask those individuals who have chosen a career in public safety to take a 1.45% cut in pay seems harsh and unfair, especially considering that many of these people could have had better paying jobs in the private sector.

As for the government share of the new tax, the liability for the Metropolitan Police Department would amount to $730,240.00 annually. (The preceding figures are based on fiscal year 1988-1989 dollars and the presumption of no growth in the number of employees within the entity.) Our Department currently is operating with a 2% vacancy factor. If the Department were to have to pay that amount in Medicare taxes, it would increase that vacancy factor by an additional 2%. In point of fact, currently, our Department has 1.4 police officers per 1,000 residents. The national average for a city the size of Las Vegas is 2.7 police officers per 1,000.

On a more down to earth level, the Department's $730,240.00 share is equivalent to 23 police officers. As our city is experiencing increasing population, we are also seeing an increase in gang and drug related activity, necessitating the formation of special squads and details. If this new tax were imposed, it would impact the Department's ability to handle these problems as they would be unable to hire those 23 officers to meet the increasing needs of the citizens of Clark County.

Another example I would cite would be the Communications Bureau, an area with which I am quite familiar, as I have been a Communications Specialist for thirteen years. We are responsible for handling all 911 emergency calls for police, fire, and medical services in addition to routine calls for police service.

At any time, it is possible that there are as few as seven operators responsible to the citizens of 7,800 square miles of jurisdictional area. If you were to make up even a part of that tax loss for Medicare coverage by further understaffing the Communications Bureau, the results could be catastrophic throughout the county, as those Communications Specialists and Police Emergency Operators are the only link between callers to 911 and emergency help. Quick response time can mean the difference between life and death.

Congress has already much debated the mandatory Medicare coverage issue. A compromise was reached in the Consolidated Omnibus Budget Reconciliation Act of 1985. This compromise mandated a gradual phasing in of employees outside the Medicare system by covering under Medicare all employees hired after March 31, 1986. Eventually, all public employees will be covered through the approximately 9% attrition rate in the public sector. This allows the employer to gradually increase their budget to meet the needs of the new tax, rather than being shouldered with a huge tax burden all at once. To now propose mandating coverage for all public employees seems to show "bad faith" in the compromise negotiations that were reached in COBRA.

We urge you to totally reject the extension of mandatory Medicare coverage to all state and local government employees, once and for all. Thank you for the opportunity to express our views before this Committee.

Chairman **Rostenkowski**. Mr. Flaherty.

STATEMENT OF WILLIAM J. FLAHERTY, DIRECTOR, OHIO DEPARTMENT OF ADMINISTRATIVE SERVICES

Mr. **Flaherty**. Mr. Chairman, members of the committee, thank you for this opportunity to appear before you.

I am here today on behalf of Governor Celeste of Ohio and I speak in opposition to the early imposition of the Medicare tax upon public employers and employees.

I am director of the Ohio Department of Administrative Services and I serve as a board member of the Public Employees Retirement System.

This proposal will effect 45,000 State employees and 413,000 local government employees in Ohio. Nationally, 4 million employees of State and local governments will be effected.

In 1985 this issue was debated in Congress and this committee, with the assistance of Congressmen Pease and Gradison, learned of the severe adverse impact it would have on State and local government's budgets. As a result of those deliberations, the 1985 COBRA Act contained a compromise. All State and local governments would pay their tax for employees hired after March 31, 1986. This gradual implementation provided State and local governments an opportunity to plan to meet their new payroll liability.

Since the implementation of the COBRA compromise, 22 percent of all public employees and 28 percent of all State government employees in Ohio have begun paying into the Medicare system. Local governments will pay $23 million and the State government of Ohio will pay $4.7 million in 1989. Enactment of the Executive Budget Request would cost the Ohio State government $19 million and Ohio local governments $123 million in the first year. It would cost the average State employee $381.

If the current agreed-to compromise remains, 44 percent of all public employees in Ohio will pay the Medicare tax in 1990. By 1996, 60 to 70 percent of all public employees in Ohio will be paying this tax.

The President's proposal does not recognize the work and eventual compromise achieved 3 years ago. Its imposition would jeopardize other State funded program initiatives. The States cannot afford unplanned expenditure. The 1985 COBRA compromise was an example of Federal, State, and local governments working together and resolving a conflict through discussion and compromise. This proposal ignores the work of the committee and the Congress in 1985 because it has an adverse impact on State and local government budgets, I urge you not to accept it.

Thank you for this opportunity.

Chairman **Rostenkowski**. Thank you, Mr. Flaherty.

[The statement of Mr. Flaherty follows:]

TESTIMONY OF WILLIAM J. FLAHERTY, DIRECTOR, OHIO DEPARTMENT OF ADMINISTRATIVE SERVICES

Good morning Mr. Chairman and members of the Committee. Thank you for inviting me to testify. My name is William J. Flaherty. I am Director of the Ohio Department of Administrative Services. My department is the chief administrative agency in the state and would be responsible for administering any change in the Medicare system. I am also on the Board of Directors of the Public Employees Retirement System, the pension system to which most state employees belong. Mr. Chairman, on behalf of Governor Richard Celeste, I wish to register Ohio's opposition to the imposition of a mandatory Social Security Health Insurance Trust Fund tax (commonly called Medicare) on state and local government employees hired before April 1, 1986. We oppose imposition of this tax because it goes counter to the compromise Congress made in 1985. Before I further explain our position, a bit of history may be helpful.

Ohio has five public state pension systems: the State Teachers Retirement System (STRS), the Public Employees Retirement System (PERS), the School Employees Retirement System (SERS), the Police and Firemen Disability and Pension Fund (PFDPF), and the Highway Patrol Retirement System (HPRS). If President Bush's Medicare proposal is accepted, 45,045 state employees and 413,000 public employees would have their taxes raised. Nationally, approximately four million state and local government employees would have their taxes raised.

These systems, some of which were set up before Social Security was started and certainly before Social Security was expanded to cover most workers, were designed to provide a suitable retirement income for our public employees. For many years public employees were not permitted to participate in Social Security. When Medicare was added to Social Security in the 1960's Ohio retirement systems also added medical benefits.

During the late 1970's and 1980's, as a means of strengthening the Social Security (including Medicare) Trust Fund, public pension systems were invited to join the Social Security system. (Earlier, in the 1950's, many of the poorly funded systems joined Social Security.) Ohio's five retirement systems serve over 530,000 public employees and have assets in excess of $40 billion. Unlike Social Security, which is a pay as you go system, we are prefunded. We have 225,000 retirees who are currently benefiting from our system.

In 1985, this same issue was considered by Congress. Through the efforts of this Committee, including Congressmen Pease and Gradison, the severe adverse fiscal impact that an immediately mandated tax on all employees would have on state and local governments was fully explored. As a result of those deliberations, when the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) was passed, a compromise was struck. COBRA required all state and local government employees hired after March 31, 1986 to pay the Medicare tax, 1.45 percent of gross income. The employer would pay an equal amount. While public employee retirement systems opposed mandatory inclusion, we accepted the compromise because it gradually introduced the Medicare tax and thus did not create an unplanned and substantial liability for state and local governments. The compromise recognized the equity issue involving access to Medicare benefits that others have raised.

Since the implementation of the Medicare tax in April, 1986, 117,000 (22%) of all public employees and 17,142 (28%) of all Ohio state public employees have begun paying into the Medicare system. (Please note that state employees are a subset of all public employees.) All public employees will pay a total of $23 million in Medicare taxes while state employees will pay $4.7 million in 1989. Enactment of the President's tax proposal would cost Ohio State government $19 million in the first year. Enactment of the President's proposal would cost Ohio local governments $123 million in the first year. In each case, the employee will pay an equal amount. Mr. Chairman, although we are a large system, this is not an insignificant amount.

If the current system remains in place, approximately 44% of all Ohio public employees will be paying the Medicare tax by 1990 and by 1996, 60-70% of all Ohio public employees will be paying into the system. The President's proposal does not recognize the work and eventual compromise achieved three years ago between the federal government and state and local governments.

Imposition of a Medicare tax would come at a time when Ohio and many other state governments are reeling from underfunded federal mandates. For example, implementation of nursing home regulations contained in the Omnibus Budget Reconciliation Act of 1987 (OBRA) will cost Ohio $41 million over the next two years. Six months ago the Administration and Congress worked out an agreement to fund the Family Support Act at $800 million, the President's budget only includes $350 million. This list goes on. States cannot afford these underfunded mandates. And when we work together to resolve a problem we are surprised that it is reopened just three years later.

In practical terms the adoption of the President's proposal would mean that the state would have to reconsider planned expansions in a host of programs including expanding child and family health clinics, training personal care workers, starting a pilot program for individuals who do not have health insurance. We also have major plans to expand alternatives to nursing homes for our elderly.

For state government employees the Medicare tax is not insignificant. The average salary of our employees who currently do not pay the Medicare tax is $26,300. This tax would reduce their annual earnings by $381.35 (1.45%).

Mr. Chairman, I hope that the Committee will reject the President's proposal to expand the Medicare tax. Thank you for allowing me to testify before the Committee. I will be happy to answer any questions.

Chairman **Rostenkowski**. Anyone of you can answer this, whoever would like to join in a conversation with me. Extending the Medicare coverage to all State and local employees would be very costly to many States, I'm sure, but over the long term what costs savings could the States achieve if Medicare picked up health costs for presently uncovered employees? Anybody have the answer to that?

Mr. **Flaherty**. Mr. Chairman, I don't think the State would have a cost savings because the public retirement systems currently have supplemental programs to those programs. Also, about 80 to 90 percent of our employees currently have access to the Medicare system because they have already met the minimum eligibility requirements by paying 40 quarters into the Social Security system from their other employment, prior to or concurrent to State service or through a spouse's eligibility.

Chairman **Rostenkowski**. Ms. Ault, maybe you could answer this. Some State and local employees, because they work for a State that has not voluntarily agreed to participate in Medicare, get no Medicaid coverage at all or no Medicare coverage at all. Are you concerned about the lack of Medicare coverage for individuals in these States?

Ms. **Ault**. I certainly can't speak for other States. In the State of Nevada, we have a well in place health plan for our retirees. I don't foresee that that would be a problem in Nevada. I don't think it would be a problem.

Chairman **Rostenkowski**. Well, I'm concerned about the other States that have not voluntarily agreed. I mean, where do we get coverage for people like this?

Mr. **Schaitberger**. I think you find, Mr. Chairman, that most of the States, at least many of the States that have significant noncoveraged public employee populations, their retirement programs, in fact, provide fairly generous and sophisticated post retirement health care plans so that retirees, in fact, do receive health care benefits and coverage in those areas, including the State of Ohio, Colorado and several others.

Chairman **Rostenkowski**. Any other member? Mr. McGrath.

Mr. **McGrath**. Mr. Chairman, I just want to thank the panel for coming. The last response sounds a lot like the response we get from those senior citizens at the present time who are now covered under Medicare by the new catastrophic healthcare benefits who do not want to pay for it. They say simply leave us alone and we will take care of ourselves. I just wonder, frankly, whether or not somewhere later down the road a 21-year-old would say, "Dad, don't tax us for this Medicare. Let us take care of ourselves. Let me take care of my own health responsibilities somewhere down the road and for the next 45 years I will save for that." I wonder what would happen to the system if that were the committee's present attitude?

I think we are pretty well down the road on this Medicare proposal and I think we need to find ways of financing it equitably. I am not sure whether this is equitable or not, but I do know that in a lot of cases those in some of these states where it is not mandatory, do pick up the coverage through employment plans other than the public employment and municipal employment plans that they have. I am not sure what the incidence is, but somebody told me in the neighborhood of 80 percent of employees who are not covered or do not have to pay are covered later on in life anyway through employment outside of the municipal employment. I am not going to tell you that I have a good answer for it or how to rectify the problem, but I will tell you that it is a concern of mine.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I just want to pursue your initial question a little further. I am sorry I did not hear all of your testimony, but I did hear some of you saying that local government provides very good retirement health care for their employees. In my experience as a State senator I do not think that blanket statements about local government are particularly accurate. Some of my local governments provide essentially nothing for their retirees. These employees must then depend on doing what Mr. Flaherty said. They find coverage for Medicare by working the necessary quarters to qualify.

Laying that aside for a minute, if government is providing health care coverage for their retirees and, therefore, does not want to be part of Medicare, how do you anticipate government will be able to meet the rapid escalation of those health costs? Business is beginning to look at its retirement liability. Business is providing a richer and richer health care program for retirees. Are you really going to be able to fund what we are having a very hard time funding? That is my first question.

Mr. SCHAITBERGER. Well, at least in partial response, I think it's very important, Mrs. Johnson, to remember that we're not talking about not covering public workers under Medicare. We're talking about an orderly transition that this committee and the Congress agreed to in 1985 to, in fact, reach that ultimate goal but to do so in a manner which will cause the least financial impact on State and local government and on the employees involved since those employees and those governments were forced by the lack of coverage to put into place programs to provide coverage. I think that the compromise allowed to work, that we will simply find ourselves in the middle of the next decade with virtually all workers covered, but done so in a way that can be done in an orderly fashion and the least disruptive fashion.

Mrs. JOHNSON. Would the rest of the panelists generally agree with that?

Mr. FLAHERTY. Mrs. Johnson, yes. I think that's the point that I was trying to make earlier that what we see is a transitional period based on the 1985 COBRA compromise. And right now States are already building their budgets. We've already—we're in the final stages of passing our budget for the next biennium, which will take us through expenditures through July 1991. We don't anticipate this type of expenditure. We do anticipate living with the COBRA compromise and to change the procedures on which we should be building our budget now will have an adverse effect on other State programs.

Mrs. JOHNSON. Thank you. That narrows the debate a little bit. The problem with the COBRA compromise is very clearly seen through the figures that you gave us. By 1996 you said that 70 percent of your employees will be paying. Now, however, ninety percent are enjoying the benefits. Eighty to ninety percent of public employees are enjoying the benefits of Medicare, but they have qualified through very minimal participation. We are already providing benefits that cost more than the amount anyone is contributing. Ninety percent of our public employees are getting a benefit for which they contributed very little. For us to have to look at 1996 for maybe 50-percent coverage nationwide is a budget problem for us.

As a new member of this committee, it seems to me that the phase-in program which we established is not good enough because its attrition turnover in local and State government is not apparently as rapid as we anticipated. If we are only going to get 56 to 60 percent coverage by 1996, then I think we have to think about what other phase-in and what other predictable changes we can make to insure that 100 percent is achieved.

Are there any comments?

Mr. **Flaherty**. Congresswoman, we agree that bringing the folks in is a direction that the compromise was designed to achieve. The question is how do State governments afford unplanned expenditures at this point? We're concerned in terms of developing our budgets and our projections to know what the base has to be early enough to plan for that. And we've been working off of the compromise.

Mrs. **Johnson**. I appreciate your effort. I think we need to honor it. We also need to look at how you can cut your premium costs as the coverage changes for your employees. I do not think we can simply say that the phase-in compromise is enough when, at least for Ohio, by 1996 it is going to be only 60 percent or possibly while we are holding 100 percent.

Mr. **Schaitberger**. Mrs. Johnson, if I may, I just want to make sure that when you're talking about 90 percent of the employees receiving the benefit and then in 1996 only 50 or 60 percent would be paying in, I would just want to call your attention that we're not talking about 90 percent of all public employees. Right at this moment over 70 percent of all public employees are in the system. We're talking about less than 30 percent of public employees of the State and local government who are not in the system and it's that 28 percent of which we are now talking about the 50 or 60 percent coverage.

So we're not talking about the public employee population as a whole. We're talking about a piece, a smaller piece of the total.

Mrs. **Johnson**. Of the 70 percent, we are not talking about the 70 percent being covered not because they have been contributing over their lifetime, but because they contributed the minimum quarters?

Mr. **Schaitberger**. The 70 percent are in the system because their State and local governments are, in fact, in the Social Security and Medicare systems. Over 70 percent of State and local government workers are covered in the Social Security system and have been.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Mr. Chairman, I don't have any questions. I'd just like to thank all the members of the panel, tell them that I found their testimony to be extremely persuasive, since I already held that view anyhow. Finally, to commend in particular Mr. Flaherty from the State of Ohio who, Mr. Chairman, I would point out to you is from long experience to my knowledge a very good example of a dedicated public servant.

Thanks.

Mr. **Flaherty**. Thank you, Congressman.

Chairman **Rostenkowski**. Mr. Moody.

Mr. **Moody**. Thank you very much, Mr. Chairman.

I'm in agreement with the panel, so please understand my questions are a bit on the devil's advocate side, but I want to press them anyway for a moment.

Mr. Seward, first of all, you said you mentioned the woes of Alaska and then you noted that the Congress wants to propose this tax. You know, it isn't us who is proposing this tax.

Mr. **Seward**. I understand that.

Mr. **Moody**. It's the President. It's President Bush. When his OMB Director was in here, Dick Darman, we asked him why doesn't this fail the duck test? Isn't this a new tax? He said it is not a new tax because President Bush was part of a Reagan/Bush administration which proposed it earlier. Therefore, it's not new.

Mr. **Seward**. OK.

Mr. **Moody**. Then he went on to point out that many States, knowing what President Bush stands for, voted to reelect using his term, "the same team" I believe your State of Alaska voted for President Bush and the team which had proposed this last time.

Do you think that the grassroots people in Alaska feel like you do since they've, obviously, endorsed a team that had this as one of its continuing proposals?

Mr. **Seward**. I think the employees of the Alaska State Employee Association feel the way I do. We have great faith in our new supplemental benefit system and in our retirement system. We've only been in it for about 9 or 10 years. So our current retirees are taking advantage of Medicare, but they've been paying into the system for years as we were a territory and as a young State. They have great faith in our program. We see this as a new tax.

Mr. **Moody**. So you don't agree with Dick Darman that it's an old tax proposal?

Mr. **Seward**. No; we see it as a new tax.

Mr. **Moody**. OK.

Mr. **Seward**. It's going to hurt our State budget a lot.

Mr. **Moody**. I'm a former State legislator, so I sympathize with much of what's been said here. But I just wanted to make a point. My State of Wisconsin works very hard at tax effort. We have a high State income tax and one of the things we pay is fairly decent fringe benefits to our State employees.

Does Alaska do that?

Mr. **Seward**. We have fairly decent benefits to our State employees.

Mr. **Moody**. Do you have a State income tax?

Mr. **Seward**. We do not have a State income tax, no. It is under debate in the legislature.

Mr. **Moody**. You see, it's a little hard for us to come to sit here and feel sorry for States that don't even have State income taxes.

You see what I'm saying? Other States don't have the richness of oil. That's been a source of tragedy lately but it's been a tremendous revenue source for your State, so you enjoy the benefit of not having to have a State income tax while we bust a gut, to provide humane benefit levels for our State employees. Your tax effort is much, much less.

One thing this administration's proposal would do, although I'm not supporting it, at least it would provide a kind of uniformity and require States to provide a State tax effort in a way which they're not all doing now.

Let me ask Mr. Seward to comment and then anyone can comment. You see my point? We're working hard in Wisconsin with State income tax to provide levels of benefits for State employees to have health care coverage. When we see States that don't even bother to have State income taxes and have very low rates of taxation, it makes it a little harder to sell the idea that they're in a difficult spot.

The last time I knew Alaska even handed out money to its citizens instead of taxing them.

Mr. **Seward**. We do have a permanent fund divide in Alaska which each resident benefits from annually. I would defer to Mr. Carlson of my State who works with division of retirement.

Mr. **Carlson**. Our State employees and public employees in general in Alaska pay 6.75 percent of their gross income to the retirement system. One of the points we were trying to make is that we have not received a pay increase in 4 years now and it's unlikely that we will now. In fact, one of the points Mr. Seward made is that many employees may be laid off here pretty soon because of the oil money dwindling.

Mr. **Moody**. Well, maybe it's time for you to have a revenue device inside your State that prevents those kind of——

Mr. **Carlson**. That is one of the proposals of the Governor's.

Mr. **Moody**. I know I'm probably lecturing to the choir here, because you probably already support that idea. I'm supporting your position, I wanted you to know. But for States that work hard at raising the money internally to cover these kind of things, it's a little hard for us to feel sorry for a State that hasn't even bothered to do that or hasn't decided not to do that in its own house.

Mr. **Seward**. Well, reading the papers in Fairbanks, AK, I can assure you that the citizens of my State are not going to favor an income tax to pay for my Medicare benefits. It would have the exact opposite effect in my State.

Mr. **Moody**. Yes, but we have decided to do that in a number of States. In fact, exactly because we believe that that's what public employees are entitled to.

Anyone else want to join my comments?

Ms. **Titcomb**. I just wanted to comment that we in Maine do have an income tax which we're wrestling with as there are a lot of problems with it right now. But presently citizens of Maine are struggling with the property taxes and all the other escalating costs that are driving people from their homes, frankly, frightening people. These types of changes, fiscal changes, all I can liken it to is having purchased a home on a mortgage and having the bank suddenly come in and say that they're calling the mortgage in and it has to be paid up front, when in fact the agreement had been that it would be paid over a period of time. This sort of impact is of great concern to me on a local level as well as through the State.

Mr. Moody. Right. We understand that. My time's up, but three quarters of the money we raise in our State income tax in Wisconsin goes to payment to individuals to lighten things like property tax. We have a circuit breaker property tax relief to exactly handle the point you make. But we recognize that a State income tax is the most productive revenue source to do those kinds of things.

Anyway, I won't belabor the point. Thank you.

Chairman Rostenkowski. If there are no more questions, I want to thank you all for joining us this morning. You've been very helpful.

Mr. Kertzman, Mr. Caufield, Mr. Bloomfield, Mr. Brown.

We appreciate you joining us this morning. You know our format here. We allow you to insert in the record your entire statement. If you'd like to summarize it in the 5 minute period that we've allocated to you, we appreciate that. If, however, you want to read your testimony and bring it down to a concise 5 minutes, we appreciate that, too. And immediately after that we'll engage with you in some conversation.

Mr. Kertzman, if you will begin your testimony.

STATEMENT OF MITCHELL E. KERTZMAN, PRESIDENT, COMPUTER SOLUTIONS INC., AND CHAIRMAN, DOMESTIC POLICY COMMITTEE, AMERICAN ELECTRONICS ASSOCIATION

Mr. Kertzman. Thank you, Mr. Chairman and members of the committee. It's an honor to be invited to testify.

My name is Mitchell Kertzman. I am the founder and president of Computer Solutions in Burlington, MA. We are a computer software company that I started in 1974 and we provide productivity software to manufacturers all over North America.

I am also representing the American Electronics Association, which represents more than over 3,500 electronics companies. We represent the largest manufacturing industry in the United States by a considerable margin in employments. About two-thirds of AFA's members are smaller companies.

I come here to speak in favor of, not necessarily specifically the President's proposal, but in favor of lower taxes on capital gains. We support proposals on capital gains that encourage new investment of equity capital into job creating companies. As an example, at my own company, we had venture capital invested starting in 1983. Since 1983, we have created more than 100 jobs in 15 States. We've run the company from about $1 million in revenue to $15 million in revenue and we serve approximately 600 American manufacturing companies who, together, produce over $10 billion GNP. So that relatively small venture capital investment has been extremely productive in my company. It's also helped the stock options we provide to our employees, help provide them an incentive to share in the growth of the company.

I'd also like to speak personally in the sense that we hear a lot of theory and a lot of speculation about how business people really make decisions. Does the Tax Code really effect the way business people make decisions? What impact does it have?

I'm a guy that runs a company everyday. I'm up here taking a day off from running my company to do that. I'll tell you a little bit about how I think the Tax Code has effected my company specifically.

On a personal note, I'm also speaking here as a businessman on a business panel, including the investor to my right. But I'm also a Democrat from Massachusetts and I sometimes feel that when I'm in a group of business people identifying myself as a Democrat from Massachusetts is somewhat akin to saying I'm a Sandinesta. Then when—I'm in Massachusetts and I tell people I'm going to Congress to speak about capital gains, then I'm a fat cat. What I've found and I've observed is that is fairly easy to put labels on this issue and the issue is, in many cases, a cause for some people, it's an emotional issue. I would like to try to focus on what I think are a couple of assumptions that we hold in common on both sides of the political spectrum and to try to understand how capital gains effects that.

The first is an issue that the American Electronics Association has been deeply involved with for many years. That issue is American competitiveness. It's very difficult to judge what causes competitiveness problems or what relates to that, but one absolute hard and fast fact is that we in the United States have a significantly higher cost of capital than our international competitors.

Now, I'm not saying that the capital gains preference, by any means, levels the playing field in cost of capital. There are a lot of factors involved. But the tax on capital gains is a part of the cost of capital equation.

From that point of view, people look at the data and say that venture capital doesn't seem to have dried up since the 1986 Tax Act. Well, the issue isn't just the availability of capital, it's the cost of the capital. That's a very important factor.

If you talk to manufacturing companies, the 600 companies that we serve in helping to improve their productivity, and you ask the CEO's of those companies the single most important factor in their investment decisions in what they invest in and where they invest in it, they'll tell you it's cost of capital.

The second issue is that I think we all agree that there's great cry for management of American companies to think more long term. Think more strategically. Invest for the future. It strikes me that the capital gains preference, assuming that it is focused to equity investments and job-creating companies, the kind that made my company grow, really sends a message from the Congress, from the country to the business people in this country saying we want you to think long term.

I started my company in 1974. My investors invested in 1983. Six years later they're still holding their investment and probably will for a few more years. From that point of view, we are open to fairly long holding periods for this kind of incentive. It's a very important incentive, not just for my investors but for my company and my employees.

I am not a fat cat. I've been working at building a company. I do not have a portfolio of investments. My entire stock portfolio is the stock that I hold in my own company. The incentive for me to make that worth money and to benefit from that, that's my sweat equity and it's the sweat equity of my employees.

I'd like to close by giving you the real world example of how the 1986 Tax Act changed things in my company, which is that one of the common ways to recruit senior executives from larger companies to a company like mine, a smaller company, is to offer them stock options. It's a very positive way for a company that would like to invest as much of its available cash as possible into development and growth.

Since the 1986 Tax Act, there has been a genuine shift in the compensation focus of executives we recruit toward cash compensation away from stock. They've noticed the difference in the capital gains and the impact that it has on stock. As a result, hiring people costs me more money, money that I could be investing in my company.

That summarizes my remarks. I have formal remarks on the record. Thanks for the opportunity to testify.

Chairman ROSTENKOWSKI. Thank you, Mr. Kertzman.

[The statement of Mr. Kertzman follows:]

STATEMENT OF MITCHELL E. KERTZMAN
PRESIDENT, COMPUTER SOLUTIONS, INC.
BURLINGTON, MASSACHUSETTS
on behalf of the

AMERICAN ELECTRONICS ASSOCIATION
April 13, 1989
WASHINGTON, D.C.

MR. CHAIRMAN AND MEMBERS OF THE PANEL, MY NAME IS MITCHELL KERTZMAN, AND I AM THE FOUNDER AND PRESIDENT OF COMPUTER SOLUTIONS, INC., OF BURLINGTON, MASSACHUSETTS. SINCE 1974, COMPUTER SOLUTIONS HAS MANUFACTURED COMPUTER SOFTWARE FOR INDUSTRIAL APPLICATIONS IN ACCOUNTING, MARKETING AND MANUFACTURING. WE EMPLOY MORE THAN 100 PEOPLE AND HAVE ABOUT $15 MILLION IN ANNUAL SALES.

TODAY, I AM HERE REPRESENTING THE AMERICAN ELECTRONICS ASSOCIATION (AEA), WHICH CONSISTS OF OVER 3,500 ELECTRONICS MANUFACTURERS ACROSS THE NATION.

MR. CHAIRMAN, THE ELECTRONICS INDUSTRY IS NOW THE LARGEST MANUFACTURING INDUSTRY, EMPLOYING MORE THAN 2.6 MILLION AMERICAN WORKERS. OVER THE PAST FIVE YEARS, GROWTH RATES FOR THE ELECTRONICS INDUSTRY HAVE BEEN 50 PERCENT GREATER THAN THOSE OF THE ECONOMY AS A WHOLE. WE ARE ALSO AN EXPORTING INDUSTRY. ON AVERAGE ELECTRONICS COMPANIES EXPORT OVER 20 PERCENT OF THEIR PRODUCTS EACH YEAR.

MR. CHAIRMAN, CRITICAL TO UNDERSTANDING THE U.S. ELECTRONICS INDUSTRY IS AN AWARENESS OF ITS MANY LINKS. THE SURVIVAL OF EACH UNIT IN THE ELECTRONICS FOOD CHAIN -- MATERIALS, MANUFACTURING EQUIPMENT, SEMICONDUCTORS, CIRCUIT BOARDS, COMPUTERS, SYSTEMS, AND SOFTWARE -- IS CRITICAL TO ALL OF THE OTHER ELEMENTS OF THE CHAIN. FINALLY, ONE SHOULD NOT VIEW JOB CREATION WITHIN THE ELECTRONICS INDUSTRY ITSELF AS THE SINGLE MOST IMPORTANT BENEFIT TO THE ECONOMY. RATHER, THE MOST IMPORTANT ROLE THAT THE HIGH TECHNOLOGY INDUSTRY PLAYS IS TO PROVIDE THE TOOLS FOR WORKERS IN OTHER SEGMENTS OF THE ECONOMY TO BOOST THEIR PRODUCTIVITY AND COMPETITIVENESS.

DESPITE THE APPARENT SUCCESS OF OUR INDUSTRY, HOWEVER, THE U.S ELECTRONICS INDUSTRY IS IN TROUBLE. SINCE THE EARLY 1980S, THE U.S. ELECTRONICS INDUSTRY HAS WITNESSED ITS WORLD MARKET SHARE DECLINE DRAMATICALLY. IN 1985, THE YOUNG COMMISSION WARNED THAT SEVEN OUT OF 10 TEN AMERICAN TECHNOLOGY SECTORS HAD LOST WORLD MARKET SHARE SINCE 1965. IN JUST THE PAST FEW YEARS, OUR INDUSTRY HAS SUFFERED MARKET SHARE DECLINES IN SILICON WAFERS, SEMICONDUCTORS, DRAMS, ASICS, MICROPROCESSING UNITS, AND MICROLITHOGRAPHY.

THE COST OF CAPITAL

NOW, HOW CAN OUR INDUSTRY GROW BUT AT THE SAME TIME LOSE MARKET SHARE? WELL, THE ANSWER IS THAT OUR FOREIGN COMPETITORS ARE GROWING EVEN FASTER. AND WHILE THERE ARE VARIED AND PROFOUND REASONS FOR THIS, CLEARLY THE HIGH COST OF U.S. CAPITAL PLAYS AN IMPORTANT ROLE.

U.S. COMPANIES TODAY FACE CAPITAL COSTS THAT ARE FOUR TIMES THOSE OF JAPANESE COMPANIES. A U.S. COMPANY ACTING RATIONALLY CAN FORSAKE $1.00 OF CURRENT EARNINGS FOR $1.20 IN FUTURE EARNINGS ONLY IF THE PAYOFF COMES IN THREE YEARS. A JAPANESE COMPANY ACTING RATIONALLY CAN WAIT FOR 12 YEARS FOR THE SAME INVESTMENT TO PAY OFF.

CLEARLY THE UNIQUELY STEEP U.S. TAX ON NOMINAL CAPITAL GAINS INCREASES THE COST OF CAPITAL, OFTEN MAKING INVESTMENTS IN SOME OTHER COUNTRY MORE ATTRACTIVE. AS YOU WELL KNOW, MANY COUNTRIES IMPOSE NO CAPITAL GAINS TAX AT ALL ON THEIR STOCK MARKETS, INCLUDING HONG KONG, SOUTH KOREA, MALAYSIA, SINGAPORE.

THE ROLE OF A CAPITAL GAINS DIFFERENTIAL

BY AND LARGE, CAPITAL GAINS ARE NOTHING MORE THAN THE INCOME INVESTORS RECEIVE FROM INVESTING IN GROWING BUSINESSES. IT IS THESE GAINS THAT SPUR PEOPLE TO INVEST. WHEN YOU REDUCE THE FEDERAL TAXES ON THESE GAINS, YOU ENCOURAGE GREATER INVESTMENT IN BUSINESSES. IN TURN, YOU ENCOURAGE BUSINESSES TO PURCHASE NEW PLANT AND EQUIPMENT AND YOU CREATE JOBS. LOTS OF JOBS.

I AM NOT ADVOCATING SUPPLY SIDE ECONOMICS HERE; I AM ADVOCATING COMMON SENSE.

A WEST GERMAN INVESTOR INVESTS IN A GERMAN COMPANY AND KEEPS THE PROFIT. THAT'S AN INCENTIVE.

AN AMERICAN INVESTOR MAKES THE SAME INVESTMENT IN AN AMERICAN FIRM AND LOSES 28 PERCENT OF THE PROFIT TO THE FEDERAL GOVERNMENT. THAT REPRESENTS A DISINCENTIVE. INDEED, THE HIGH COST OF CAPITAL IN THE UNITED STATES IS A MAJOR REASON FOR LOW INVESTMENT RATES, WHICH IN TURN EXPLAINS LAGGING U.S. COMPETITIVENESS. LET ME ADD THAT IT IS NOT THE "AVAILABILITY" OF CAPITAL THAT'S AT ISSUE HERE, BUT RATHER IT'S COST.

THE BOTTOM LINE THEN IS THAT HIGH U.S. TAXES ON CAPITAL GAINS DISCOURAGES INVESTMENT AND INHIBITS THE CREATION OF JOBS THAT FOLLOWS. THIS IS KNOWN ONLY TOO WELL BY AMERICA'S ELECTRONIC AND HIGH TECH COMMUNITY. A RECENT STUDY BY GEORGE MORGAN, AN ECONOMIST AND A PROFESSOR AT VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY, CONCLUDES:

> A SIGNIFICANT FEATURE OF TAX REFORM IS SHOWN HERE TO BE THE ABOLISHMENT OF THE CAPITAL GAINS TAX PREFERENCE. THE ABOLISHMENT OF A CAPITAL GAINS TAX PREFERENCE IMPLIES DISASTROUS RESULTS FOR THE CONTINUED GROWTH OF THE HIGH TECH SECTOR THAT IS CREDITED WITH AN INSTRUMENTAL ROLE IN THE GROWTH OF THE U.S. ECONOMY IN THE 1980S. REINSTATING A GAINS TAX ADVANTAGE MAY BE A KEY TO CONTINUED ECONOMIC GROWTH, PARTICULARLY AS RELATED TO THE HIGH TECH SECTOR.

CAPITAL GAINS DIFFERENTIAL: A TIME TESTED PUBLIC POLICY

MR. CHAIRMAN, WE LIVE IN A GLOBAL ECONOMY AND IF WE ARE TO SUCCEED IN THAT ARENA, WE MUST NOT HANDICAP AMERICA'S ENTREPRENEURS; WE MUST ENCOURAGE THEM. IF NATIONS PROVIDE THEIR CITIZENRY WITH POSITIVE INCENTIVES THAT WE NEGLECT, THEN AMERICA IS LEFT AT A DISADVANTAGE.

I BELIEVE THAT IS THE CASE WITH CAPITAL GAINS. AS SENATE MAJORITY WHIP ALAN CRANSTON NOTED IN A RECENT FLOOR STATEMENT, "WE MUST SHIFT OUR HORIZONS AND STOP MAKING THE AMERICAN ENTREPRENEUR THE ENEMY. WE MUST SUPPORT LONG TERM INVESTMENT, ENCOURAGE CUTTING EDGE TECHNOLOGY, AND RENEW -- WITH GUSTO -- OUR BELIEF THAT AMERICA IS READY AND CAPABLE OF MEETING THE CHALLENGES BEFORE US."

ALMOST 11 YEARS AGO, AEA COMPLETED A SURVEY OF U.S. ELECTRONICS MANUFACTURERS THAT FOUND THE POOL OF VENTURE CAPITAL FUNDS AVAILABLE TO FINANCE ENTREPRENEURS AND START-UP COMPANIES WAS, IN REAL TERMS, AT IT'S LOWEST LEVEL IN 15 YEARS. AFTER THE CAPITAL GAINS TAX INCREASED IN 1969 FROM A TOP RATE OF 25 PERCENT TO 49 PERCENT, THE ABILITY OF SMALL COMPANIES TO RAISE EQUITY CAPITAL BY PUBLIC STOCK ISSUES DECLINED DRASTICALLY, AND BY 1973 SMALL COMPANY ISSUES ALMOST CEASED.

MANY COMPANIES WERE TURNING TO JAPAN TO SHARE THEIR PROPRIETARY SECRETS IN EXCHANGE FOR FUNDING THAT COULDN'T BE FOUND IN THE UNITED STATES. ONE EXAMPLE WAS SYSTEM INDUSTRIES, THE COMPANY FOUNDED BY AEA'S 1978 CONGRESSIONAL WITNESS WHO WAS A YOUNG ENTREPRENEUR AND LATER BECAME A CONGRESSMAN--ED ZSCHAU.

WHILE THE 1978 SURVEY WAS GENERALLY GLOOMY, THERE WAS ONE BRIGHT SPOT. THE RESULTS DEMONSTRATED THAT THOSE SMALL COMPANIES WHICH WERE SUCCEEDING--OFTEN WITH GREAT DIFFICULTY--WERE MAJOR SOURCES OF NEW JOB CREATION IN THE UNITED STATES. THIS LED AEA TO SUGGEST THAT IF THE POOL OF VENTURE CAPITAL AVAILABLE TO START AND SUPPORT SMALL COMPANIES WAS INCREASED, IT COULD PROVIDE A MAJOR SOURCE OF NEW JOB CREATION IN THE UNITED STATES.

THE 1978 (AND 1981) CUTS IN CAPITAL GAINS TAXES RESULTED IN A TREMENDOUS ENTREPRENEURIAL SUCCESS STORY. THE EXPLOSIVE GROWTH OF NEW INVESTMENTS IN SMALL FIRMS HELPED CREATE OVER ONE MILLION NEW JOBS IN ELECTRONICS BETWEEN 1978 AND 1984. ONE INDICATION OF THE ELECTRONICS INDUSTRY'S NATURE AND GROWTH IS REFLECTED IN AEA'S MEMBERSHIP OF AEA'S 3,500 HIGH TECHNOLOGY MANUFACTURERS, NEARLY HALF (45 PERCENT) HAVE BEEN CREATED SINCE 1978.

WHILE THE CIRCUMSTANCES OF EACH COMPANY'S FORMATION WERE AND ARE DIFFERENT, THOSE OF US WHO HAVE "BEEN THERE" STARTING AND RUNNING COMPANIES KNOW THAT MANY FIRMS WOULD NOT EXIST TODAY HAD THE WAYS AND MEANS COMMITTEE AND CONGRESS NOT ACTED SOME 11 YEARS AGO.

CAPITAL GAINS AND THE 1986 TAX REFORM ACT

MR. CHAIRMAN, THE 1986 TAX REFORM ACT BROUGHT MANY GOOD THINGS TO OUR TAX SYSTEM, AND THE AEA WAS AMONG THOSE ORGANIZATIONS WHICH GAVE ITS OVERALL SUPPORT TO THE LEGISLATION.

WE HAVE ALWAYS BEEN CONCERNED, HOWEVER, AT WHAT HAPPENS TO THE ELECTRONICS INDUSTRY WHEN YOU TREAT CAPITAL GAINS AS ORDINARY INCOME. WE ARE A HIGH RISK INDUSTRY, AND IN ORDER FOR SUCCESS, INVESTORS MUST BE ASSURED OF A POTENTIAL HIGH RETURN ON THEIR INVESTMENT. THAT HIGH RETURN NEED NOT BE IMMEDIATE, BUT IT MUST BE THERE SOMEWHERE ON THE HORIZON. OTHERWISE, WHY TAKE THE RISK? WHY NOT INVEST IN SAFER, SHORT-TERM, INCOME-ORIENTED TRANSACTIONS? AS A MAY, 1988, VENTURE MAGAZINE ARTICLE NOTED, "WHEN VENTURE CAPITALISTS CAN GET A FAIRLY SAFE 35 TO 50 PERCENT ON A LEVERAGED BUYOUT, WHY ACCEPT A POTENTIAL 50 PERCENT ON A START-UP THAT CARRIES MORE RISK?"

MR. CHAIRMAN, AS NOTED BY ALAN REYNOLDS OF POLYCONOMICS, INC. THESE SMALL INVESTORS AND ENTREPRENEURS HAVE ANOTHER HUGE DISADVANTAGE UNDER CURRENT TAX LAW. THOSE WHO CAN AFFORD LARGE, DIVERSIFIED, PORTFOLIO OF STOCKS, BONDS, AND REAL ASSETS WILL HAVE A REASONABLE BALANCE OF LOSSES TO OFFSET GAINS. THESE INDIVIDUALS CAN DELAY CASHING IN THEIR GAINS EXCEPT WHEN THERE ARE ENOUGH LOSSES TO RESULT IN LITTLE OR NO TAX LIABILITY. ENTREPRENEURS, HOWEVER, CAN AFFORD NO SUCH LUXURY. AN ENTREPRENEUR PUTS ALL HIS ENERGY AND ASSETS INTO A SINGLE VENTURE. IF THE ENTREPRENEURIAL VENTURE SUCCEEDS, THE FEDERAL AND STATE GOVERNMENTS WILL OFTEN TAKE MORE THAN A THIRD OF THE GAIN FROM GOING PUBLIC OR SELLING OUT. IF THE VENTURE FAILS, THE ENTREPRENEUR HAS NO GAINS TO OFFSET HIS LOSS. THE GOVERNMENT SHARES IN THE BENEFITS, NOT THE LOSSES.

MR. CHAIRMAN - THERE IS A WIDESPREAD BELIEF THAT LOWER CAPITAL GAINS TAXES ARE UNFAIR AND REPRESENT A WINDFALL TO THE RICH. WELL, LET ME SAY THAT AEA'S INTEREST IS IN HELPING THE ENTREPRENEUR, NOT THE "FAT CAT." NEARLY THREE QUARTERS OF AEA'S MEMBER COMPANIES ARE SMALL BUSINESSES EMPLOYING FEWER THAN 200 PEOPLE. OUR INTEREST IS IGNITING AMERICA'S ENTREPRENEURIAL SPIRIT. WE WANT TO PROMOTE ENTERPRISE, INNOVATION AND EXCELLENCE IN TECHNOLOGY.

CLEARLY, ENTREPRENEURS NEED THE WEALTHY TO INVEST IN THEIR IDEAS, SINCE ONLY THE WEALTHY CAN AFFORD TO DO SO. BUT FAIRNESS IS NOT DETERMINED BY WHETHER THE WEALTHY WILL INCREASE THEIR WEALTH. FAIRNESS IN THE CONTEXT OF CAPITAL GAINS POLICY IS DETERMINED BY WHETHER GOVERNMENT POLICY WILL ENCOURAGE THE WEALTHY TO INVEST THEIR FUNDS IN RISKIER, JOB CREATING VENTURES OR SEEK SAFE HAVENS.

CAPITAL GAINS AND THE REVENUE DEBATE

I AM RELUCTANT TO DELVE TOO FAR INTO THE DEBATE ON WHETHER LOWER TAXES ON CAPITAL GAINS RAISES OR LOSES REVENUE BECAUSE THERE IS LITTLE THAT I CAN ADD. AS A MATTER OF RECORD, AEA AGREES WITH THE U.S. TREASURY AND THOSE ECONOMISTS WHO BELIEVE THAT LOWERING CAPITAL GAINS INCREASES -- RATHER THAN DECREASES -- REVENUE. HISTORY SHOWS THIS TO BE THE CASE. IN 1978, THE MAXIMUM RATE WAS REDUCED FROM 49 TO 28 PERCENT. ALTHOUGH THE RATE WAS ALMOST CUT IN HALF, TAX REVENUES WENT UP. IN 1981, CONGRESS CUT THE CAPITAL GAINS TAX RATE FROM 28 TO 20 PERCENT. AGAIN, REVENUES INCREASED.

ADDITIONALLY, MR. CHAIRMAN, LET ME WARN OF A GROWING MISCONCEPTION THAT ENTREPRENEURS RELY LARGELY ON NON-TAXABLE SOURCES OF INCOME, SUCH AS PENSION FUNDS, FOR THEIR FUNDING. THAT SIMPLY IS NOT THE CASE. A UNIVERSITY OF NEW HAMPSHIRE SURVEY OF 284 NEW COMPANIES FOUND THAT INDIVIDUALS WERE THE MAJOR SOURCE OF FUNDS FOR NEW COMPANIES RAISING $500,000 OR LESS AT THE TIME. INDIVIDUALS PROVIDING START-UP CAPITAL FOR THESE NEW FIRMS PAY CAPITAL GAINS TAXES AND ARE SENSITIVE TO AN INCREASED TAX RATE ON CAPITAL GAINS.

CONCLUSION

FINALLY, LET ME SAY THAT AEA'S INTEREST IN CAPITAL GAINS IS FOCUSED ON LOWERING THE COST OF CAPITAL -- ON MAKING THE SMALL ENTREPRENEUR MORE COMPETITIVE. WE ARE OPEN TO PROPOSALS -- LONG HOLDING-PERIODS, FOR EXAMPLE -- THAT COULD LIMIT THE REVENUE IMPACT OF A DIFFERENTIAL.

IN THE END, I DO NOT BELIEVE THE QUESTION IS, "CAN WE AFFORD LOWER TAXES ON CAPITAL GAINS. NO, THE QUESTION IS, "HOW CAN WE AFFORD NOT TO LOWER TAXES ON CAPITAL GAINS?" TODAY, THE SINGLE GREATEST REASON FOR LAGGING U.S. COMPETITIVENESS IS THE HIGH COST OF CAPITAL. DISTINGUISHED MEMBERS OF THIS COMMITTEE, WE NEED TO TURN THAT SITUATION AROUND. LOWERING TAXES ON CAPITAL GAINS WILL NOT GUARANTEE SUCCESS OR A MORE COMPETITIVE AMERICA. BUT IT WILL HELP SEND A POWERFUL SIGNAL THAT -- FOR ON NOW -- AMERICA PLAYS ON A LEVEL PLAYING FIELD.

AND ONCE THAT HAPPENS, THE AMERICAN ELECTRONICS INDUSTRY -- AND THIS NATION -- WILL DO MORE THAN "COMPETE". WE WILL SUCCEED.

Chairman **Rostenkowski**. Mr. Caufield.

STATEMENT OF FRANK J. CAUFIELD, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION AND PARTNER, KLEINER PERKINS CAUFIELD & BYERS

Mr. **Caufield**. Mr. Chairman and members of this committee, my name is Frank Caufield. I'm a partner in the venture capital firm of Kleiner Perkins Caufield & Byers located in San Francisco. I'm appearing before you this morning in my capacity as president of the National Venture Capital Association, the NVCA.

Since its formation in 1973, the NVCA has grown to represent 238 venture capital firms which currently provide approximately $3 billion per year in equity capital to small high growth companies.

Today, I'm here to urge you to lower the tax rate on capital gains. The reasons for that, I feel, are compelling.

That America faces a crisis in terms of its economic competitiveness is widely known and accepted. We're slipping from the world's No. 1 economic power to a secondary position with slower growth in our standard of living and diminished world influence. Foreign competitors have obtained the upper hand in a multitude of industries from steel to semiconductors to VCR's.

America's economic decline has been correctly ascribed to a number of causes, including the overemphasis by business on short-term profits rather than stable long-term investment, the higher cost of capital, and an erosion in our traditional technological and innovation leadership.

Unfortunately, our current tax policy hurts us in all these areas. It rewards the short-term business and investment view, it encourages speculation while it hinders the efforts of small American companies to raise capital. The 1986 Tax Reform Act penalized long-term productive investment by increasing the long-term capital gains tax rate by 40 percent from 20 percent to 28 percent, at the same time the act provided a boon for short-term speculators by cutting their tax rate almost in half from 50 to 28 percent. Our tax policy then, in effect, is channeling funds away from the long-term investments which are crucial to our economic vitality. Likewise, taxing capital at a higher rate than our competitors, we greatly increase the cost of capital to business and discourage the investment needed to keep America competitive.

Our foreign competitors, it should be noted, such as Japan, West Germany, and Korea suffer no such handicap. Indeed, in these countries the tax rate on long-term capital gains is negligible.

History has shown that when tax rates on capital gains are raised, entrepreneurs suffer. Entrepreneurs are at the cutting edge of innovation in our society. They bring to fruition the technology of tomorrow which, in turn, creates good jobs, a high standard of living, and ensures America's continued competitiveness. Taxing income and capital gains at the same rates severely discourages entrepreneurs from leaving secure high-paying jobs to undertake the high risk of starting a new technology venture.

Another important point is that alongside the organized venture capital pool there exists an informal pool, harder to measure but conservatively estimated to be many times larger. These private individual investors are often the very first backers of new ideas and they were affected very adversely by the increase in capital gains tax rates and, of course, will now find short-term investing relatively more attractive.

Such was the case in 1969 when Congress raised the capital gains tax rate from 25 to 49 percent. The amount of investments for new expanding businesses dried up to the point where in 1974 a total of only $10 million was raised in the organized venture capital industry. When Congress recognized the problem, it cut the capital gains tax to 28 percent in 1978 and then down to 20 percent in 1981. These changes greatly encouraged the large increase in the formation of new companies, new jobs and new exports that followed.

Providing entrepreneurial firms with long-term low-cost capital also benefits the economy through a multiplier effect. A recent study of over 500 technology firms concluded that it takes $69,000 of equity to produce one new job. Each investment of $100 in equity capital brings benefits throughout the economy. Each year it provides $68 of exports, $13 of research and development, and $8 of State and Federal taxes. Our Nation loses this economic leverage every time we, through our Tax Code, remove capital dollars from the process and promote short-term low-risk investments promising quick returns, thus reducing the capital gains tax rate is crucial to assuring America's continuation as a major force in world markets.

No discussion of capital gains taxes, however, would be complete without addressing the fairness issue. We believe that this is an important issue, that the United States Tax Code must be fair and must be perceived as fair. The extent to which the rich benefit disproportionately has been wildly exaggerated. In fact, IRS data showed that approximately 50 percent of all capital gains go to people with recurring earnings of less than $60,000 annually. Nevertheless, fairness remains an issue. Definitions of fairness will vary. Clearly, the definition is more emotional and ideological than quantitative.

There are many ways to achieve fairness in the Tax Code. One way it should not be achieved is through a flawed and counter productive tax policy that weakens our economy and makes all Americans poorer.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Caufield.

[The statement of Mr. Caufield follows:]

TESTIMONY

FRANK CAUFIELD
PRESIDENT
THE NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. Chairman and members of this Committee, my name is Frank Caufield. I am a partner in the venture capital firm of Kleiner Perkins Caufield & Byers, located in San Francisco, and I am appearing before you this morning in my capacity as president of the National Venture Capital Association (NVCA). Since its formation in 1973, the NVCA has grown to 238 venture capital firms which currently provide approximately $3 billion per year of equity capital to small, high-growth companies.

Today, I am here to urge you to lower the tax rate on capital gains. The reasons are compelling.

That America faces a crisis in terms of its economic competitiveness is widely known and accepted. We are slipping from the world's number one economic power to a secondary position with slower growth in our standard of living and diminished world influence. Foreign competitors have obtained the upper hand in a multitude of industries, from steel to semiconductors to VCRs.

America's economic decline has been correctly ascribed to a variety of sources, including the over-emphasis by business on short-term profits rather than stable, long-term investment, a higher cost of capital and an erosion in our traditional technological and innovative leadership.

Unfortunately, our current tax policy hurts us in all these areas. It rewards the short-term business and investment view. It encourages speculation while it hobbles the efforts of fledgling American companies to raise capital. The 1986 Tax Reform Act penalized long-term, productive investment, by increasing the long-term capital gains tax rate by 40%, from 20% to 28%. At the same time, the Act provided a boon for short-term speculators and corporate raiders by cutting their tax rate almost in half, from 50% to 28%. Our tax policy, in effect, is channeling funds away from the long-term investments which are crucial to our economic vitality. Likewise, by taxing capital at a higher rate than our competitors, we greatly increase the cost of capital to business and discourage the investment needed to keep America competitive.

History has shown that when tax rates on capital gains are raised, entrepreneurs suffer. And entrepreneurs are at the cutting edge of innovation in our society. They bring to fruition the technology of tomorrow, which in turn creates good jobs, a high standard of living and ensures America's continued competitiveness. Taxing current income and capital gains at the same rate severely discourages entrepreneurs from leaving secure, high-paying jobs to undertake the great risk of starting a new technological venture.

Alongside the organized venture capital pool there exists an informed pool of individual investors--harder to measure but conservatively estimated to be many times larger. These private individual investors are often the very first backers of new ideas and were affected very adversely by the increase in capital gains tax rates. They now find short-term investing relatively more attractive.

Such was the case in 1969, when Congress raised the capital gains tax rate from 25% to 49%. The amount of investments for new and expanding businesses dried up to the extent that in 1974, a total of only $10 million was raised in the organized venture capital industry. When Congress recognized the problem, it cut the capital gains tax rate to 28% in 1978 and then to 20% in 1981. These changes greatly encouraged the large increase in the formation of new companies, new jobs, and new exports which followed.

Let's not have Congress make the same mistake again by maintaining the current capital gains tax policy. What happened in 1969 could recur, unless we take prompt action to correct it.

America has already lost global dominance in many industries, and will continue to lose it in others if changes are not made to arrest this erosion. The crisis we are speaking of is long-term in nature; its full repercussions may not be felt for another five to ten years. In the meantime, how many more of our young growth industries will be outstripped by foreign competitors?

Crisis situations demand bold actions. This is no time to vacillate. A simple change--namely, reducing the tax rates on capital gains--could do much to remedy this situation. Our foreign competitors--such as Japan, West Germany and Korea--suffer no such shackles; indeed, in these countries, the tax rate on long-term capital gains is negligible. Changing our policy in this area becomes all the more important, as the European countries prepare to unify their markets in 1992 and the Pacific Rim nations continue their rapid penetration of our markets.

Many of our foreign competitors in growth industries enjoy government subsidies, mandated by a national industrial policy. We are not advocating this remedy, because entrepreneurialism--relatively unassisted and unfettered by government--has always been, and continues to be, the driving force behind America's new industries. It is the incubator for innovation. Since 1970, Fortune 500 companies have lost more than six million jobs. By contrast, small businesses have added millions to their payrolls. These are high-quality jobs at good wages, in fields like biotechnology and microcomputers that are at the forefront of the global marketplace. More than 500,000 new businesses are started every year in the United States, and over half are begun by women. America, more than any other country, has encouraged this kind of individual initiative as a route to upward mobility. We must continue to encourage it as part of the promise of the American Dream.

It is entrepreneurial drive, fueled by venture capital funds, that brought to life Apple Computer, the company that first developed the personal computer; Federal Express, which revolutionized overnight delivery of business information and products; and Genentech, the pioneer in the development and commercialization of biotechnology products.

We are, furthermore, operating in the age of the information economy. The companies that are quickest and most flexible in adapting to change will succeed. Entrepreneurial firms--in contrast to big companies--are ideally suited to prosper in this environment, if they can raise enough long-term capital.

The most ambitious among them need huge amounts of risk capital to get their businesses off and running. On average, they use $20 million during their firms' first six years of life. Equity capital remains the lifeblood of these firms which lack sufficient credit history to tap into the debt markets.

Providing entrepreneurial firms with long-term, low-cost capital also benefits the economy through a multiplier effect. Our recent study of over 500 technology firms--with an average age of 14 years--concluded that it takes about $69,000 of equity capital to produce one new job. Each one-time investment of $100 in equity capital generates $68 of exports; $13 of research and development; and $8 of State and Federal taxes annually. Our nation loses this economic leverage every time we, through our tax code, remove capital dollars from the process and promote short-term, low-risk investments promising quick returns.

Thus, reducing the capital gains tax rate is crucial to assuring America's continuation as a major force in world markets.

And at what cost to our government? Would tax revenue be lost? We think not. In recent testimony before the Senate Finance Committee, the Treasury Department estimated a cumulative revenue gain from the President's capital gains tax proposal of $9.3 billion through 1994, whereas the Joint Committee on Taxation estimated a cumulative loss of $24.2 billion through the same time period. We think the Treasury is closer to correct but no one really knows. In any event, if reality is somewhere in the middle, the cost is modest compared to the benefits we've outlined.

But what about the costs of inaction? The difference between Treasury and Joint Tax is primarily due to different estimates of the rate at which taxpayers will choose to realize capital gains. That's not the real issue. The real issue is the long-term cost to our country of not remaining competitive in the technologies of tomorrow--like biotechnology and superconductivity. We can't afford to take that risk!

In recent interviews, both Felix Rohatyn and Henry Kaufman have voiced strong support for reduction of the capital gains tax rate. As Henry Kaufman told Business Week:

"There's a debate as to how much tax will be lost. Some say there's a loss; others say there's a gain in revenue. [But] I don't think this should be tackled on the basis of revenue lost. What is at stake here is the nature of our economic and social society over the long run. It's something much more fundamental, [yet] we're worried because there's a shortfall in the budget."

No discussion of capital gains would be complete without addressing the "fairness" issue. We believe it important that the U.S. tax code be fair and also be perceived as fair.

The extent to which the rich benefit disproportionately has been wildly exaggerated by a form of double-counting. For example, when a middle-class businessman retires and sells his business, the capital gain swells his income to several hundred thousand dollars and he is "rich" for that year, despite the fact that the following year his salary returns to its previous level of, say, $70,000.

The IRS data show that people with recurring annual income below $20,000 receive a larger proportion of capital gains than those earning over $200,000. More importantly, approximately 50% of all capital gains go to people with recurring incomes of less than $60,000 annually.

Nevertheless, fairness remains an issue. Definitions of fairness will vary; clearly, the definition is more emotional and ideological than quantitative. There are many ways to achieve "fairness" in the tax code. However, it should not be achieved through a flawed and counter-productive tax policy which weakens our economy and makes all Americans poorer.

Chairman ROSTENKOWSKI. Mr. Bloomfield. Delighted to have you.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. BLOOMFIELD. Thank you, Mr. Chairman. My name is Mark Bloomfield, I am president of the American Council for Capital Formation. I very much appreciate the opportunity to testify today.

The American Council for Capital Formation hopes that the President's capital gains initiative is the beginning of a constructive and bipartisan debate on the appropriate taxation of capital gains. Today, I hope to contribute to this dialog by commenting on the economic significance, the fairness, and the revenue consequences of restoring a capital gains tax differential.

The thrust of my oral testimony is that a capital gains tax differential, be it the President's initiative or perhaps a better congressional alternative, has important and beneficial economic consequences which should be considered separately from the ongoing debate about the revenue and distributional implications of a capital gains tax cut. Briefly put, the economic significance of the restoration of a capital gains tax differential is in its impact on U.S. saving, the cost of capital, international competitiveness, and entrepreneurial effort.

First, U.S. saving. Recent testimony before the Congress on corporate restructuring and the U.S. budget deficit has focused on the problem of our low national saving rate. Reducing the budget deficit will curtail Government dissaving but steps to increase private saving are also needed. A discussion of the taxation of capital gains should be looked at in the context of our current tax laws which tend to encourage consumption and discourage saving.

There is a large body of economic research, including that of Harvard Prof. Lawrence Summers and Stanford Prof. John Shoven showing that savers do indeed respond positively to higher after tax rates of return. The President's proposal will help reduce the bias against saving by increasing the after tax rate of return on realized capital gains.

Second, the cost of capital. There is an overwhelming concern among economists and policymakers about the cost of capital in the United States. Lower capital costs, economists agree, promote higher investment. This increases the Nation's capital stock and provides more capital per worker, greater productivity and growth in a country's standard of living.

The capital gains tax is an important element of the cost of capital and again the President's proposal should be judged in that context. Consider that the capital costs of investing in machinery and equipment, where you get your greatest productivity gains, rose substantially in the period between 1981 and 1986 rising, according to the Congressional Research Service, by approximately 26 percent for manufacturing.

These increases have contributed to a level of overall capital costs in this country that experts estimate are 50 to 75 percent higher than Japan and also higher than those of other industrialized countries. Such high capital costs will sooner or later slow our already lagging investment per worker, further impede productivity growth and hurt competitiveness.

Capital gains tax rates, Mr. Chairman, matter for this purpose and they matter a lot. Research by Dr. Yolanda Henderson, an economist with the Federal Reserve Bank of Boston, shows that the Tax Reform Act of 1986 significantly increased overall U.S. capital costs. Dr. Henderson concludes that, had the capital gains tax not been raised in 1986, the cost of capital for U.S. business would have risen only half as much as it did.

According to simulations based on the Washington University Macroeconomic Model, if the President's proposal were enacted, the overall cost of capital for U.S. firms would decline approximately 11 percent and capital costs for the important equipment and machinery sector would fall by 14 percent. A decrease of that magnitude would materially reduce the cost of funds to U.S. firms and help narrow the gap between capital costs in the United States and abroad.

Restoration of a reasonable capital gains tax differential as proposed by President Bush will by no means bring our capital costs to a satisfactory level but it certainly would be an important first step.

Third, international comparisons. Our research and that of others confirm that U.S. capital gains taxes are among the highest in the world. Research indicates that the favorable treatment of capital gains in Germany and Japan is an important element in their lower overall capital costs. Again, the President's proposal will reduce the U.S. disadvantage.

Fourth, entrepreneurial effort. Restoring a capital gains tax differential, as illustrated by the witnesses on this panel, will have a particularly powerful impact on the entrepreneurial sector of the American economy, making possible new technological breakthroughs, new startup companies and new jobs.

In conclusion, although there is considerable controversy over the revenue consequences and fairness of the President's capital gains initiative, a very strong and credible case can be made that this initiative, with its very important economic consequences, will not reduce revenues and, in fact, is a revenue raiser.

In my written testimony and in a more technical paper prepared for this hearing, I have commented extensively on the revenue implications and fairness consequences of the President's capital gains tax proposal. I'm particularly prepared to respond to the differences between the Treasury and Joint Committee on these issues including the assertion by the Joint Committee that to raise revenue, the President's capital gains proposal would require a doubling of realizations and that there is no historical or little theoretical support for that proposition.

Thank you.

Mr. JENKINS. Thank you very much.

[The statement and attachment of Mr. Bloomfield follows:]

Statement of
Mark A. Bloomfield, Esq., President
American Council for Capital Formation
before the
House Committee on Ways and Means

Thursday, April 13, 1989

Introduction

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation. I appreciate this opportunity to present testimony in support of President Bush's capital gains tax proposal. The American Council for Capital Formation hopes that the President's capital gains tax initiative is the beginning of a constructive dialogue on capital gains tax reform.

The history of this debate is not partisan, with support for a capital gains tax differential coming from both Democrats and Republicans. A capital gains tax differential enjoyed bipartisan support from the tax-writing committees in the 1978, 1981, 1986, and 1987 debates on this issue. Eleven years ago this month, a majority of Democratics and a majority of Republicans on this committee, by a vote of 25 to 12, approved a modified version of the well-known Steiger proposal.

Almost two years ago, this committee held hearings on the revenue-raising potential of a 15 percent capital gains tax rate as a revenue option for a balanced deficit reduction package for FY1988. This first forum for the 15 percent solution, which predated President Bush's initiative, was triggered by a 1987 survey of leading academic and government studies. The survey concluded that the revenue-maximizing capital gains tax rate is in the range of 9 percent to 21 percent. The 15 percent proposal, championed first by several Ways and Means Committee members and later by President Bush, is based on this research.

In the current debate, prominent individuals who have spoken out in favor of a reduced tax on long-term capital gains include Michael Blumenthal, Secretary of the Treasury in the Carter Administration; prominent investment bankers Felix Rohatyn and Henry Kaufman; and Nobel prize winner James Tobin, a member of the Council of Economic Advisers during the Kennedy Administration.

The President's capital gains tax initiative differs from traditional capital gains tax cut proposals in that it has been carefully crafted to maximize revenue to the Treasury and investment in the U.S. economy. This capital gains tax cut would be available to all taxpayers through a 45 percent exclusion. Very significantly, taxpayers with adjusted gross incomes of $20,000 or less would not have to pay a capital gains tax, which is fair since many of them would be paying the tax on purely inflationary gains. Collectibles are excluded and we applaud the Administration's goal of forestalling tax sheltering, although we would suggest alternative mechanisms. There should be a thorough debate on the proposed longer holding period, which is a break with historic levels in the tax code. One should balance the desirability of capital liquidity on the one side with the merits of encouraging long-term investment on the other. We also are unaware of any tax policy reason for excluding corporations from a capital gains tax differential and there are numerous good reasons why they should be included.

Today, I hope to contribute to the current debate by commenting on the economic significance, the fairness, and the revenue consequences of restoring a capital gains tax differential. The thrust of this testimony is that a capital gains tax differential, be it the President's initiative or a Congressional alternative, has important and beneficial economic consequences which should be considered separately from the ongoing debate over the revenue implications of the proposal for the Federal Treasury. My testimony also addresses the revenue raising potential of such a tax change.

Before I begin my testimony, I should say something about the American Council for Capital Formation and our role in the capital gains tax debate. The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to promote jobs, growth and competitiveness. For more than a decade, we have focused much of our attention on the impact of tax policy on saving and investment. In particular, we have been involved in the debates of 1978, 1981, 1986 and 1988 about the appropriate taxation of capital gains.

The Economic Significance

The restoration of a capital gains tax differential will have economic significance for U.S. saving, the cost of capital, international competitiveness and entrepreneurial effort.

- ### U.S. Saving

Recent testimony before Congress on corporate restructuring and on the problem of the U.S. budget deficit has focused on the problem of our low national saving rate. Reducing the budget deficit will curtail government dissaving but steps to increase private saving are also needed. A discussion of the taxation of capital gains should be looked at in the context of our current tax laws which tend to encourage consumption and discourage saving. Consumption today costs less in terms of foregone future income because income is taxed before it can be saved. Furthermore, any income that flows from the investment of those savings is also taxed again. If income which is saved--and the further income it generates--were exempt from tax, the cost of current consumption compared to what could be consumed in the future would rise and the incentive to save would be strengthened.

The Tax Reform Act of 1986 substantially increased the bias against saving by imposing one of the largest capital gains tax rate increases since the advent of the capital gains tax differential in 1922. This change took place unfortunately in the context of an increasingly competitive world where most nations tax capital gains more lightly than we did even before the capital gains tax rate increase in the 1986 act. There is a large body of economic research, including that of Harvard Professor Lawrence Summers and Stanford Professor John Shoven, showing that savers do respond positively to higher after-tax rates of return. The capital gains tax increase of the 1986 act reduced after-tax rates of return to investors and therefore made saving considerably less attractive.

- ### The Cost of Capital

There is a growing concern among economists and policymakers about the cost of capital in the U.S., which is considerably higher in our country than in Japan, West Germany and most of our other competitors. Lower capital costs promote higher investment. This increases a nation's capital stock and provides more capital per worker, greater productivity, and growth in a country's standard of living. The capital gains tax is an important element of the cost of capital and the President's initiative should be judged in that context.

Taxes directly influence the user cost of capital, which is the return on a new investment required to cover the marginal cost of the investment given the market rate of interest, the rate of inflation, economic depreciation and the taxes levied on the income from the investment. Capital gains tax rates have a significant impact on the cost of capital faced by business because of their impact on the "hurdle rate" which new investment projects are required to meet. Lower capital gains taxes mean that for any given after-tax rate of return required by investors, the pretax return can be smaller and, thus, the cost of capital firms face is lower. As a consequence, more projects will meet the new lower, hurdle rate and investment will be encouraged.

The question raised by President Bush's proposal to cut capital gains taxes is simple but of great importance: Are policy makers prepared to take the first important step in reversing recent tax policy which has impaired this nation's future international competitiveness by sharply increasing the capital costs of investing in productive equipment? Make no mistake about it, a high and sustained rate of investment in modern, state-of-the-art equipment is essential to U.S. competitiveness; it is the only way our high-wage economy can restore the productivity growth that allows us to compete with low-wage industrial nations around the world.

The capital costs of investing in equipment rose substantially between 1981 and 1986, rising (according to the Congressional Research Service) by approximately 26 percent for manufacturing and 23 percent both in oil and gas activity and construction. These increases have contributed to a level of overall capital costs in this country that experts estimate are 50 to 75 percent higher than in Japan, and also higher than in other industrial nations abroad. Such high capital costs are bound, sooner or later, to slow our already lagging investment per worker, further impede productivity growth, and hurt competitiveness.

The 26-percent rise in the capital costs of investing in new manufacturing equipment reflected three recent major tax actions: repeal of the investment tax credit, lengthening of depreciation lives, and elimination of the capital gains tax differential. Restoration of a reasonable capital gains differential, as proposed by President Bush, will by no means restore our capital costs for equipment to a satisfactory level, but it would be an important first step in reversing a very dangerous Federal tax policy.

For new endeavors, including venture capital projects, the capital gains tax rate is an especially important component of the cost of capital. For example, Dr. J. Gregory Ballentine, an economist with KPMG Peat Marwick, estimates the cost of capital for investments yielding capital gains increased by 12 percent after the 1986 tax changes relative to an investment yielding ordinary income such as dividends.

Furthermore, research by Dr. Yolanda Henderson, an economist with the Boston Federal Reserve Bank, also shows that the capital gains tax provisions of the Tax Reform Act of 1986 significantly increased overall U.S. capital costs. Dr. Henderson concludes that, had the capital gains tax not been raised in 1986, the cost of capital for U.S. business would have risen only half as much as it did.

According to simulations based on the Washington University macroeconomic model developed by Laurence H. Meyer & Associates, if the President's proposal were enacted, the overall cost of capital for U.S. firms would decline approximately 11 percent and capital costs for equipment would fall by 14 percent. A decrease of that magnitude would materially reduce the cost of funds to U.S. firms and help narrow the gap between capital costs in the U.S. and abroad.

The cost of capital has been estimated in several studies to be higher in the United States than in several foreign competitor nations. In a paper prepared for the American Council for Capital Formation Center for Policy Research, Dr.

John Shoven, chairman of Stanford University's Economics Department, found that after the 1986 tax act, the cost of capital in the U.S. was 63 percent higher than in Japan, 26 percent higher than in Germany, and 81 percent higher than in the United Kingdom. The 1989 Economic Report of the President, prepared by the Council of Economic Advisers, notes the tax burden on corporate equity capital in the U.S. is much higher than the burden for many of our competitors. Higher capital gains taxes exacerbate this spread and further reduce saving and investment incentives.

The linkage between the cost of capital, which is influenced by tax policy, and a country's standard of living is described in a 1988 article by Thermo Electron Corporation Chairman George Hatsopolous, MIT economist Paul Krugman, and Harvard Professor Lawrence Summers. The authors explain that the cost of capital is much lower in Japan with the result that investment in plant and equipment per worker in that country is twice as high as in the U.S. This helps explain the higher productivity in Japan and the faster growth in the Japanese standard of living.

For these and other reasons, business economists overwhelmingly support a reduction in capital gains tax rates. According to a survey of the National Association of Business Economists released February 27, 1989, by a margin of 79 percent to 21 percent, the economists said the President's capital gains tax proposal will improve capital formation.

- International Comparisons of Capital Gains Taxation

The U.S. taxation of capital gains should also be analyzed in the context of the treatment afforded capital gains by our international competitors. They recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation. An Arthur Andersen & Co. study comparing tax rates on corporate stock found that U.S. capital gains taxes are among the highest in the world. (See Table 1, page 5.) Germany, Japan, and South Korea, among others, either exempt long-term capital gains on portfolio stock from tax or tax gains only lightly. As Dr. Shoven's research makes clear, the favorable treatment of capital gains in Germany and Japan is an important element in their lower capital costs.

- Entrepreneurial Effort

Restoring a capital gains tax differential will have a particularly powerful impact on the entrepreneurial sector of the American economy, making possible new technological breakthroughs, new startup companies, and new jobs. Venture capital requires a number of participants: entrepreneurs, informal investors, venture capital funds, and finally, healthy public markets. All of these participants are sensitive to after-tax rates of return. The key to successful venture investment is the ability to attract and motivate the entrepreneur. By taxing the entrepreneur's potential gain at a higher rate, either the pool of qualified entrepreneurs will be reduced or the investors will have to accept a lower rate of return. In either case, the implications for the American economy are clearly negative.

Furthermore, fledgling companies depend heavily on equity financing from family, friends, and other informal sources. Professors William E. Wetzel and John Freear of the University of New Hampshire surveyed 284 new companies and found that private individuals were the major source of funds for those raising $500,000 or less at a time. The individuals providing startup capital for these new companies do pay capital gains taxes and are sensitive to an increased tax rate on gains.

It is true that a portion of the organized venture capital pool comes from tax-exempt entities, but the informal pool is equally important. Data collected by the National Venture

Table 1: Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investments in 1989

COUNTRIES	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
INDUSTRIALIZED				
United States (A)	33.0%	33.0%	One Year	None
Australia (B)	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (C)	17.51%	17.51%	None	None
France (D)	16%	16%	None	None
Germany (E)	56%	Exempt	Six Months	0.5%
Italy	Exempt	Exempt	None	None
Japan (F)	5%	5%	None	None
Netherlands	Exempt	Exempt	None	0.8%
Sweden	45%	18%	Two Years	3.0%
United Kingdom (G)	40%	40%	None	None
PACIFIC BASIN				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

*State, provincial and local taxes not included.

(A) The nominal tax rate for long- and short-term capital gains is 28 percent. The marginal rate, however, rises to 33 percent for joint returns between $74,850 and $155,370 and for single returns between $44,900 and $93,130 for calendar year 1989.

(B) Indexing is allowed on long-term gains.

(C) Canadian residents are allowed an annual capital gains exemption of Canadian $ 30,000 ($22,998**) subject to a cumulative exemption of up to Canadian $500,000 ($383,300**) in 1990.

(D) Gains from proceeds of up to FF 272,000 ($45,288**) are exempt from taxation in a given taxable year.

(E) The first DM 1,000 ($554**) of short-term capital gains is exempt from tax.

(F) Japan's tax reform plan, which takes effect in 1989, imposes a maximum tax of approximately 5 percent on the sale of securities.

(G) Only gains and losses accrued since 1982 will be taxed; gains since 1982 are indexed.

** Based on exchange rates as of March 31, 1987.

Source: Prepared by Arthur Andersen & Co., for the Securities Association in March 1987; updated by the American Council for Capital Formation Center for Policy Research, March, 1989.

Capital Association documents the fact that private taxable investors, including corporate venture capital funds, provide on an informal basis as much funding as does the organized venture capital industry. Most importantly, it is the taxable investors who, more often than not, provide the seed corn for the new firms, with tax exempt pension funds and formal venture capital pools entering the funding process at a later stage. The willingness of tax exempt entities to participate in the venture capital process is also dependent, to a very large extent, on a vibrant stock market which is directly affected by the level of capital gains taxes.

The Tax Reform Act of 1986 discouraged entrepreneurial endeavors. An analysis prepared by Dr. Ballentine of KPMG Peat Marwick concludes that the 1986 act fails to recognize that many capital gains investments are inherently risky and that realized capital gains often include purely inflationary gains that are not income. In fact, the combined effect of taxing inflationary gains and limiting the deductibility of capital losses leads to severe over taxation and produces a "surtax" on many investments that will earn capital gains.

For example, assuming a 4 percent real return and 5 percent inflation, a taxpayer in the 28 percent marginal tax bracket pays a 29 percent higher tax on an asset yielding capital gains held for five years than on one which earns ordinary income, such as dividends, and which is taxed currently. Even worse, under the same assumptions, a taxpayer in the 28 percent bracket who realizes a gain on a "high risk" capital asset faces a tax rate 50 percent higher than the rate on ordinary income on an asset held five years. (See Chart 1, page 7.) Higher taxes on risky capital assets result from the fact that, while capital gains are subject to full taxation, losses are allowed only limited deductibility. These factors clearly discourage investment.

Conversely, the earlier 1978 and 1981 capital gains tax cuts proved to be an economic success story. These cuts improved the investment climate, facilitated a record number of new stock offerings, and bolstered corporate equity values and employment gains across the entire spectrum of the economy.

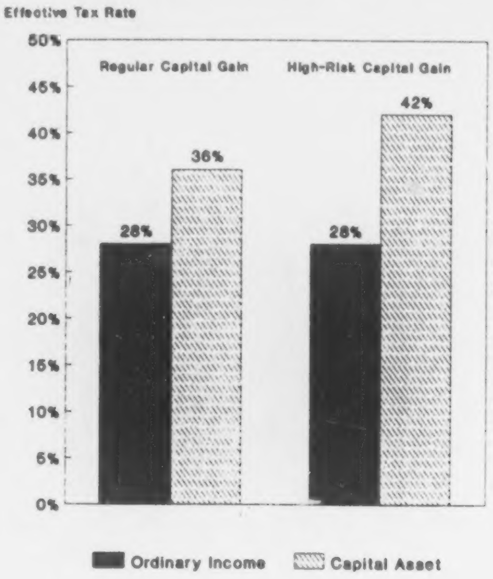
The Fairness Issue

There is much controversy about the "fairness" of capital gains tax cuts. There are two aspects to the fairness issue. What is most often discussed is the predicted distribution of taxes paid by different income classes. What, in fact, is more important is the beneficial impact to the U.S. economy and the fairness of opportunities created or lost for the less fortunate in our society, which has already been discussed in this testimony.

First, a threshold question is whether saving should be taxed at all. Many Americans, in fact, believe that saving should be exempt from taxes.

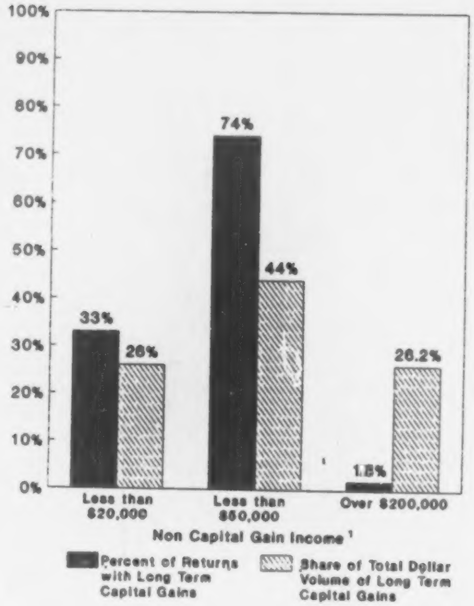
Second, many Americans believe capital gains should not be taxed or, if taxed, should be taxed lightly. For example, a November 1988 survey by the Media General/Associated Press found a plurality of poll respondents support a reduction in Federal capital gains taxes. A decade ago, in 1978, when the now well-known Steiger capital gains initiative was hotly debated in Congress and around the country, surveys of public attitudes on capital gains taxes also showed strong support for substantial cuts in gains tax rates. One such survey (Louis Harris, "The Harris Survey," August 14, 1978) asked for a reaction to this statement: "In order to get the economy going again, it is important to provide incentives for people to want to invest their money through measures such as a capital gains tax reduction." An overwhelming 70 percent agreed with this proposition.

Chart 1: Effective Tax Rate & Surtax on Regular & High Risk Capital Gains, Compared to the Tax on Current Income



Source: J. Gregory Ballentine. "The Tax Penalty on Capital Gains." August 1987.

Chart 2: Who Gets Capital Gains?



[1] Adjusted Gross Income without capital gains for 1985; the major components are wage and salary income.

Source: U.S. Department of the Treasury data March 1989. Chart prepared by the American Council for Capital Formation.

Third, contrary to what opponents of lower capital gains tax rates suggest, the American middle class, not the very wealthy, is hit hardest by the capital gains tax hikes of the Tax Reform Act of 1986. Under the 1986 act, taxpayers with incomes under $30,000 will generally see a tripling of capital gains tax rates; that is much more than the 75 percent tax hike for taxpayers earning more than $200,000. If one looks at combined Federal and state capital gains taxes before and after the 1986 act, the tax increase for the middle class is even more dramatic. According to a 1987 Arthur Andersen & Co. study, for a middle-income Arkansan, the combined capital gains tax increases by 84 percent; for a similarly situated Oregonian and Virginian by 118 percent; and for a middle-income New Yorker by 149 percent. The President's initiative corrects some of this inequity by exempting families with less than $20,000 in adjusted gross income from the tax.

Fourth, low-and middle-income taxpayers account for the vast majority of people who realize capital gains and also a large amount of actual capital gains. In 1985, the latest year for which detailed tax return data has been analyzed, one-third of all tax returns with long-term capital gains reported other income (primarily wages and salaries) of less than $20,000. Nearly three-fourths of all tax returns with capital gains had other income of less than $50,000. And less than 2 percent had other income of $200,000 or more. (See Chart 2, page 7.)

Internal Revenue Service data for 1985 show that roughly three million taxpayers with annual wage and salary income below $20,000 receive the same share of total capital gains as taxpayers with wage and salary income greater than $200,000. Moreover, nearly half of all capital gains go to people with wage and salary income less than $50,000.

Fifth, Jodie Allen, a columnist for the Washington Post, described a particular unfairness of current law in a recent article (January 11, 1989). Consider, she wrote, first a family of modest means which lives primarily on wage, salary, or pension income. It realizes a one-time capital gain on a long-held asset and incurs a 33 percent tax on a perceived gain, which may in fact be a capital loss due to inflation. Contrast this situation, Ms. Allen wrote, with that of a speculator who regularly pays only a 28 percent tax on a multi-million dollar short-term profit. Who are these low and middle taxpayers Ms. Allen writes about who occasionally realize a capital gain? My best judgment is that they are widows and retired couples living off savings, children being educated with the proceeds of a deceased parent's estate, and people receiving capital gains from the sale of property or business.

Sixth, logic, historical experience, and Treasury analysis indicate that lower capital gains tax rates coincide with higher government revenues from upper income taxpayers.

Consider the logic. The capital gains tax is a voluntary tax. Taxpayers alone can decide if and when to realize their capital gains. This is especially true of upper-income taxpayers with large, unrealized capital gains. Many commentators make the classic error of assuming the tax rate on unrealized gains for the wealthy is 28 or 33 percent when it is in fact zero. To the extent that a lower capital gains tax encourages the realization of gains that would otherwise not be triggered, the effective tax rate on that particular income rises from zero to 15 percent rather than declining from 28 percent to 15 percent.

Now, consider the historical experience. In the period 1978-85, when capital gains taxes were reduced from 50 percent to 20 percent, total individual capital gains tax receipts increased from $8.5 billion to $23.7 billion. The bulk of this new revenue for Uncle Sam came from upper income taxpayers. Total long-term capital gains realizations by those with annual incomes over $100,000 increased almost 700 percent between 1978 and 1985 compared to a 120 percent increase for those with incomes below $100,000.

Finally, consider Treasury analysis. The President's initiative clearly would add progressivity to the tax system. Treasury's analysis of the basic proposal found that there would be a 9.2 percent increase in capital gains taxes paid by taxpayers with over $50,000 of adjusted gross income and 3.1 percent reduction in capital gains taxes paid by taxpayers with $50,000 or less in income.

In short, it is important to remember that the tax yield on unrealized, locked-in capital gains is precisely zero. It is wrong to describe a capital gains tax rate reduction as a "tax break for the wealthy" when in fact the taxes paid by this sector will multiply dramatically.

Revenue Implications

In this time of severe budgetary pressures, one should take very seriously the revenue implications to the U.S. Treasury of any spending or tax initiative. There has been extensive research in academia and government on the revenue consequences of higher and lower capital gains tax rates. The findings are inconclusive but the research provides much support for a capital gains tax reduction from current law as a revenue raiser.

Before examining those findings, it is helpful to review the new analyses of President Bush's capital gains initiative by the Treasury and Joint Committee on Taxation. The Treasury estimates the President's proposal will increase Federal revenues substantially in FY 1989-93 due in large part to greater induced realizations. There will be a one-time loss in FY 1994-96 caused only by the phase-in of a new three-year holding period. In the years 1997 and beyond, the Treasury Department forecasts increased tax receipts of $1-$2 billion annually. The Joint Committee on Taxation estimates the President's proposal will result in initial revenue gains in FY 1989-90, but lead to significant losses in subsequent years.

What we can all agree upon is that the revenue dispute is not a minor one. It is in the range of $30-$40 billion over a four-year budget period. In the period 1989-93, for example, the Treasury estimates the President's proposal is a $16 billion gain; the Joint Committee estimate is a $13 billion loss. This is probably the first time there has been such a serious disagreement on revenue estimates between the Treasury Department and the Joint Committee, suggesting the immediate need to reconcile these differences and to pinpoint the underlying factors which create them.

In my judgment, the Treasury estimate of the impact of the President's capital gains tax proposal fits better with logic historical experience, and recent academic and government studies.

The logic is simple and intuitive. Economists of all persuasions--Keynesians, conservatives, supply-siders, and liberals--agree on one point: Since capital gains taxes are voluntary, higher capital gains tax rates do not necessarily result in greater revenues to the government because taxpayers may choose not to realize their gains if the tax penalty is too high. The critical question policymakers should ask is: What is the revenue-maximizing capital gains tax rate? This question should be put before the Treasury and the Joint Committee on Taxation.

The historical experience is compelling. The very recent historical experiment, when the maximum capital gains tax was cut from 50 to 20 percent, did not result in lower capital gains tax receipts. To the contrary, tax revenues from capital gains were 179 percent higher in 1985 than in 1978. Inflation and stock market fluctuations, alone, are not sufficient to explain this phenomenon. Rather, the behavioral response of taxpayers and the economy to a lower capital gains tax simply proved to be substantially greater than anticipated by official government revenue estimates.

The academic and government studies are pertinent. The Treasury estimates of "elasticity" (the level of behavioral response) are comfortably in the middle of the range reported in the studies. The Treasury estimates an elasticity of 1.2 percent in the short-run, dropping to about 1.0 in the long run, and to about 0.9 after considering the impact of converting ordinary income but before targeting the proposal for certain kinds of assets. It is my understanding that the Joint Committee on Taxation estimates employ a much lower long-run estimate of elasticity, perhaps as low as 0.7, which is within the range of the studies, but clearly at the lower end. This difference in elasticities, which may seem relatively small, accounts for the great bulk of the differences between the Treasury and the Joint Committee on Taxation estimates.

What it basically comes down to is a judgment about the level of behavioral response and the permanency of that effect. Capital gains receipts in FY 1987 (calendar 1986) provide the most recent real world example. All analysts agreed there would be some unlocking of accrued gains in 1986 in anticipation of the substantially higher capital gains tax rates in 1987 and beyond. The Joint Committee on Taxation anticipated more than an $8 billion revenue pickup in FY 1987. The actual receipts, however, were in the range of $20-$22 billion. Some assert that this was just a one-time effect, but I suggest that the historical evidence resulting from the 1978 and 1981 capital gains tax cuts shows that the revenue impact of lower capital gains tax rates is permanent rather than transitory.

Conclusion

In conclusion, the debate about the appropriate taxation of capital gains has been with us almost since the inception of the Federal income tax. From 1922 until 1986, a capital gains tax differential existed as part of U.S. tax policy for very sound economic policy reasons which are recognized by almost all of our economic competitors. A capital gains tax cut will be productive for the American economy and fair for American taxpayers. Although there is considerable controversy about the revenue consequences of the President's capital gains initiative, a very strong and credible case can be made that this initiative, with its very important economic consequences, will not reduce revenues and, in fact, is a revenue raiser.

April 10, 1989

APPENDIX

Comments on Department of Treasury and Congressional Joint Committee on Taxation Analyses of Capital Gains Revenue and Distributional Issues

by
Dr. Margo Thorning
Chief Economist
American Council for Capital Formation

I. Introduction

This paper addresses some of the revenue and distributional aspects involved in changing the current law treatment of capital gains. A careful review of available evidence suggests that the Administration's proposal may indeed raise revenue and make the tax system more progressive.

II. Capital Gains Tax Rates and Revenues:

A. Historical Experience

1. The 1978 and 1981 Tax Reductions

Research by the U.S. Department of the Treasury concludes that the combined effect of the 1978 and 1981 capital gains tax cuts was to increase Treasury revenues.[1] The study reestimated the time-series equation presented in the 1985 Treasury report, first using the original 1954-1982 sample data base and then using data revisions published subsequently.[2] Then the regression sample was extended through 1985, adding three years of data that were not available when the original report was written. A major finding of the Treasury study is that extending the regression sample through 1985 sharply increases the estimated revenue gains from the 1978 act. In particular, the Treasury study found that the assertion of Joseph Minarik, that "by 1980, the revenue gain from the 1978 law had essentially evaporated"[3] is only true when the incomplete sample is used. The Treasury study also revealed that the extended sample and the superior method used for adjusting nominal GNP for inflation yield much less severe revenue losses from the Economic Recovery Tax Act of 1981 (ERTA) than do the regressions based on 1954-82 only. When both adjustments are made, Treasury estimates that the combined effect of the two laws was a direct revenue increase of $4.7 billion over the 1979-1985 period.

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[1] "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time-Series Evidence", Treasury Bulletin, U.S. Department of the Treasury, Office of the Secretary, Spring Issue, June 1988.

[2] "Report to Congress on the Capital Gains Tax Reduction of 1978"; Office of the Secretary of the Treasury, September 1985 and "How Capital Gains Rates Offset Revenues: The Historical Evidence," Congressional Budget Office, March 1988.

Treasury Assistant Secretary Michael Darby, Robert Gillingham and John S. Greenlees (DGG) defended the Treasury analysis of the effects of the 1978 and 1981 capital gains tax cuts from criticism by Dr. Minarik in a piece in Tax Notes.[4] In the article, they note that they agree with Minarik on three points: that both time-series and cross-section analyses have strengths and weaknesses; that the two analytical approaches have complementary roles; and that their results ideally should agree. They state that the purpose of the Treasury research was, in fact, to show that a correct interpretation of the time-series evidence brings it into closer agreement with the cross-section evidence. Because the elasticity (or measure of behavioral response) is generally greater for cross section studies than for time series, estimates are based on cross section data which tends to be more optimistic about the revenue impact of a capital gains tax cut than those based on time series data. DGG comment that Minarik is disingenuous in criticizing them for putting one type of analysis "at the bottom of a two-element totem pole". Minarik has previously characterized the Treasury's time-series results as "much more meaningful" than cross-sectional predictions, and in his comment on DGG's paper, he makes a similar argument.

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[3] Joseph Minarik, "Raising Federal Revenues Through a Reduction in the Capital Gains Tax," statement before the Ad Hoc Committee on the Taxation of Capital Gains, February 2, 1988.

[4] Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Black Box Revealed: Reply to Minarik." Tax Notes, July 25, 1988.

Minarik repeatedly has warned researchers to avoid relying on cross-section evidence without being "able to find the revenues in the time-series data after the capital gains tax cut takes place." The Treasury Office of Economic Policy staff turn that comment around, stating

> If you continue to believe that the time-series evidence proves that tax cuts will lose money, if you think that the revenue-maximizing capital gains tax rate is 35 or 40 percent, you are going to have to explain why constant-dollar Federal capital gains revenues more than doubled between 1978 and 1985, while the marginal tax rate fell by around 40 percent. As we emphasized in our paper, our time-series explanation of this phenomenon is not definitive, but it is certainly informative.

2. Feldstein Analysis of the Effect of the 1978 Tax Cuts on Realizations

The Joint Committee on Taxation (JCT) testimony of March 14, 1989 before the Senate Finance Committee attempts to discount academic studies such as that by Feldstein, Slemrod and Yitzhaki, which predicted an immediate tripling in realizations as a result of the 1978 act.[5] The JCT testimony fails to note that the Feldstein study focused on the responsiveness of high-income taxpayers in realizing capital gains on corporate stock. As Feldstein et al. point out in their "reply" to Minarik, the actual data seem to support this contention.[5] Data on long-term realizations compiled by the ACCF Center for Policy Research in fact support the Feldstein analysis. As shown in Table 1, the realized long-term gain of taxpayers in the $500,000 and over Adjusted Gross Income (AGI) class more than tripled from 1978 to 1979, rising from $3.7 billion to $13.0 billion. Realizations continued to rise, and by 1982 had increased sixfold for the over $500,000 class. Indeed, for taxpayers in the $100,000 and above AGI class, realizations had almost tripled by 1981, and by 1982 they had more than tripled. Thus, the JTC's attempt to discredit the Feldstein analysis is open to serious criticism.

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[5] Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains", Quarterly Journal of Economics, Vol. 94, June 1980 and "Reply to Minarik", Quarterly Journal of Economics, Vol. 99, February 1984.

[6] Joseph J. Minarik, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Comment." Quarterly Journal of Economics, Vol. 99, Feb. 1984.

III. The Administration Proposal: Revenue Effects

A. The Proposal

The Administration's proposal would establish a maximum capital gains tax rate of 15 percent for individuals; it would not apply to corporations. The proposal would provide a 45 percent exclusion for gains on qualified assets; taxpayers with $20,000 or less in AGI (joint returns) would be eligible for a 100 percent exclusion. The proposal would require a holding period of 12 months or more for qualified assets sold in 1989, 1990, and 1992; 24 months for assets sold in 1993 and 1994; and 36 months for assets sold in 1995 and thereafter. The proposal would define capital assets as under current law, but collectibles and depreciable or depletable property would be excluded.

B. Rationale for Scoring the Proposal as a Revenue Raiser

In his recent testimony before the Senate Finance Committee, Treasury Acting Assistant Secretary Dennis E. Ross defended the revenue-enhancing capabilities of the Administration proposal (see Table 2). Ross testified that the effect of the static rate cut (line 1) would be more than offset by increased realizations (line 2). These induced gains are either accelerated from realizations in future years, are due to portfolio shifting to capital gain assets from fully taxable income sources, or taxable realizations that otherwise would have been tax-exempt because they would have been held until death, donated to charities, or realized but not reported.

In Treasury's view, its assumption regarding taxpayer responsiveness (elasticity) to the rate changes is comfortably in the middle of the range reported in the studies.[7] Treasury estimates an elasticity of 1.2 in the short run, dropping to about 1.0 in the long run, and to about 0.9 after considering the impact of converting ordinary income but before targeting the proposal for certain kinds of assets. Ross observes that estimates made by the staff of the Joint Committee on Taxation employ a much lower long-run estimate--perhaps as low as 0.7--which is within the range of the studies, but in Treasury's view clearly at the lower end. This difference in elasticities, which may seem relatively small, accounts for the great bulk of the difference between the Treasury and the Joint Committee on Taxation estimates, Ross states.

Ross also notes that even an elasticity response of slightly less than 1 will still generate a revenue increase, because taxpayers paying the highest tax rates are the most responsive to a capital gains tax decrease. Induced realizations are disproportionately distributed, with more being taxed at above-average tax rates and fewer being taxed at below-average rates. What is at issue is the elasticity of revenues with respect to rate changes, not realizations.

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[7] The level of taxpayer responsiveness is generally termed "elasticity," which in this context is shorthand for the expression "percentage increase in induced capital gains divided by the percentage decrease in the overall capital gains tax rate." Thus, a tax cut will tend to generate a revenue increase if the elasticity is estimated to be greater than 1, no change in revenue if the elasticity is exactly 1, and a revenue loss if the elasticity is less than 1.

The Ross statement is supported by the 1988 Treasury study (mentioned in part II). In their analysis of the capital gains rate cuts of 1978 and 1981, DGG found average and marginal rates do not always move proportionately and that it is the average tax rate which influences revenues. They state that "there are a number of economic explanations for these mathematical results. First, the tax cuts analyzed did not reduce the marginal tax rate by the same proportion for each taxpayer. Second, even for a given taxpayer, average and marginal tax rates did not have to change proportionately, because of movements along the rate schedule. Finally, cross-sectional evidence reveals that capital gains realizations are generally much more elastic at high than low rates. This relationship implies that a proportionate reduction in marginal tax rates will increase the share of gains taxed at the highest rates, so the average tax rate falls less than proportionately."[8]

C. Doubling of Realizations

Treasury expects the amount of realizations induced under the Administration proposal to almost double (see Table 3). Defending this estimate, Ross notes that this near doubling of realizations, from an estimated $183 billion to about $349 billion at 1989 levels, may seem remarkably optimistic until it is placed in the following perspective.

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[8] Treasury Bulletin, op.cit.

- The total accumulation of unrealized qualifying gains at the end of 1987 was an estimated $4 trillion.
- If we exclude from this figure gains on personal residences, which largely escape tax because of the rollover and one-time $125,000 exclusion, the total pool of gains that could be realized is still $2 trillion.
- The year-over-year increase in this accumulation--a good guide to the potential long-run realizations--has been running about $350 billion per year, even with personal residences excluded, and is expected to grow.

In light of historical experience, and of the large pool of unrealized gains, JTC's contention that a doubling of gains is unlikely does not seem convincing. Furthermore, realizations may not need to double if high income taxpayers' response to the Administration proposal is stronger than that of low income taxpayers because the gains of high income taxpayers would be taxed at 15 percent while those of low income taxpayers would be taxed at rates as low as 8.3 percent.

D. JTC's Estimates of Alternative Capital Gains Cut Proposals

In an April 4, 1989 revenue estimate, the JTC noted that a flat 25 percent tax rate on all assets (including depreciable property) would lead to a negligible revenue loss over five years. Subsequent conversations with JTC staff suggest that the Administration's proposal, imposed at a rate higher than 15 percent, could indeed be a revenue raiser.

IV. The Administration Proposal: Distributional Aspects

In addition to enhancing revenues, the Treasury analysis suggests that the Administration proposal will increase the amount of capital gains taxes paid by higher income classes (see Table 4). For example, taxpayers with income in excess of $50,000 would pay 86.0 percent of capital gains taxes in 1991 under the Administration proposal compared to only 84.5 percent under current law.

The JTC also presents data on the distributional impact of the Administration proposal. Their analysis, which is based on the percentage distribution of the tax burden rather than on tax paid (as Treasury shows), indicates that upper income taxpayers receive most of the "benefit" of lower rates (Table 5). Taxes paid by different income classes seems to be as good a measure, if not better, of the distributional aspect of capital gains taxation as does a more ephemeral concept of tax burden.

V. Conclusion

This paper has reviewed the evidence on whether previous capital gains tax cuts increased tax revenues and finds that the evidence supports this conclusion. Examination of the Treasury and JCT on the Administration proposal suggests that the revenue maximizing rate is lower than current law.

Table 1: Realized Net Long Term Capital Gain
Less Long-Term Loss, for Selected Years,
($ in millions)

Adjusted Gross Income Class (AGI)	1978	1979	1981	1982	1983	1984	1985	1986/p	Percentage Change (1978-1986)
Under $25,000	$9,731	$13,512	$13,219	$10,210	$14,104	$17,740	$17,365	$20,344	109.1
$25,000-50,000	9,026	12,189	10,214	8,468	14,582	11,681	13,834	24,315	169.4
$50,000-100,000	6,608	9,467	11,227	10,189	16,692	19,496	24,402	41,286	524.8
Sub-Total	25,365	35,168	34,660	28,867	45,378	48,917	55,601	85,945	238.8
$100,000-500,000	8,607	15,582	18,984	21,338	29,801	33,197	45,393	85,682	895.5
Over $500,000	3,692	13,101	14,965	24,486	30,754	40,557	50,426	137,640	3628.1
Sub-Total	12,299	28,683	33,949	45,824	60,555	73,754	95,819	223,322	1715.8
Grand Total	$37,664	$63,851	$68,609	$74,691	$105,933	$122,671	$151,420	$309,267	721.1

p/preliminary
Source: Statistics of Income, Individual Income Tax Returns, Internal Revenue Service, various issues. Prepared by ACCF Center for Policy Research, May 1988.

Table 2

Revenue Effects of The President's Capital Gains Proposal
Fiscal Years 1989–1999

Effects of Proposal	Fiscal Years ($billions)										
	Budget Period						Longer Run*				
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Effect of Tax Rate Reduction on Existing Gains Projected For Current Law Realizations	-1.6	-11.9	-17.6	-19.1	-20.2	-21.0	-21.5	-22.0	-22.5	-23.0	-23.5
Effect of Increased Realizations	2.4	17.1	21.8	21.8	21.5	22.3	22.3	22.9	23.4	23.9	24.5
Effect of Delaying Gains Until the Effective Date	-0.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effect of Conversion of Ordinary Income to Capital Gain Income	0.0	-0.1	-0.6	-1.3	-1.9	-2.5	-2.5	-2.6	-2.6	-2.7	-2.8
Effect of Excluding Depreciable Assets and Collectibles	0.2	1.2	1.7	1.9	2.1	2.1	2.3	2.4	2.4	2.5	2.5
Effect of Phased in Three Year Holding Period	0.0	0.0	0.0	0.4	1.0	-7.4	-2.3	-11.7	-0.1	1.5	1.5
Effect of 100% Exclusion for Certain Low Income Taxpayers	-0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
TOTAL REVENUE EFFECT OF PROPOSAL	0.7	4.8	4.9	3.5	2.2	-6.8	-2.0	-11.3	0.2	1.8	1.8

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Office of Tax Analysis

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Notes: *These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.*
Details may not add due to rounding.
Disaggregated effects are stacked in sequence.
** Longer run estimates assume 1994 growth extends past the budget forecast period.*

Table 3

Realizations of Net Long Term Capital Gains Under Current Law and an Across the Board Rate Cut 1/

($ Billions)

Tax Year	Realizations Under Current Law	Realizations Under Rate Cut 1/	Change in Realizations Rate Cut 1/
1980	71	--	--
1981	78	--	--
1982	87	--	--
1983	117	--	--
1984	136	--	--
1985	166	--	--
1986	319	--	--
1987 P	140	--	--
1988 E	135	--	--
1989 E	151	288	137
1990 E	168	333	165
1991 E	183	349	167
1992 E	193	357	164
1993 E	201	367	166
1994 E	206	384	178
1995 E	210	393	183
1996 E	215	402	187
1997 E	220	412	192
1998 E	225	421	196
1999 E	230	431	201

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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

'P'. Data are preliminary and include short term capital gains.
'E'. Estimate.

Table 4

Distribution of Net Capital Gains, and Tax Liability
Under Current Law and an Across the Board Rate Cut 1/

(Calendar Year 1991, $Billions)

Adjusted Gross Income Class Under Current Law	Capital Gain Realizations		Tax on Capital Gains	
	Current Law	Rate Cut 1/	Current Law	Rate Cut 1/
Less Than $10,000	19	22	0.9	0.7
$10,000 to $19,999	7	10	0.9	0.7
$20,000 to $29,999	8	12	1.3	1.2
$30,000 to $49,999	15	29	3.3	3.6
$50,000 to $99,999	24	54	6.3	7.5
$100,000 to $199,999	23	50	6.4	6.9
$200,000 or more	86	172	22.2	23.7
TOTAL	182	349	41.3	44.3

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March 14, 1989

1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

Table 5—Distributional Effect of the President's Capital Gains Proposal,[1] 1990 Income Levels

Income class[2]	Number of returns with tax change (thousands)	Aggregate tax change (millions of dollars)	Average tax reduction (dollars)	Percent distribution of aggregate tax change
Less than $10,000	72	−15	202	0.1
$10,000 to $20,000	695	−177	255	0.9
$20,000 to $30,000	1,216	−286	235	1.5
$30,000 to $40,000	1,498	−498	332	2.6
$40,000 to $50,000	1,083	−682	630	3.5
$50,000 to $75,000	1,581	−1,270	803	6.6
$75,000 to $100,000	539	−1,011	1,876	5.2
$100,000 to $200,000	875	−3,808	4,351	19.7
$200,000 and over	376	−11,603	30,820	60.0
Totals	7,935	−19,350	2,438	100.0

[1] This calculation assumes that qualified assets are held in the same proportions across income classes as are all assets.

[2] The income concept used to place tax returns into income classes is adjusted gross income plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside build-up on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences, from passive business activities.

Source: Joint Committee on Taxation Staff.

STATEMENT OF WILLIAM J. BROWN, PROFESSOR OF LAW, UNIVERSITY OF PITTSBURGH SCHOOL OF LAW

Mr. BROWN. Thank you, Mr. Chairman.

First I'd like to start by pointing out that capital gain rules which single out that subset of income for special treatment, add phenomenal complexity to the Federal tax law. The burden, therefore, is on the proponents of capital gains legislation. Capital gains are already favored over ordinary income by the realization requirement which produces deferral and lowers the real tax burden on capital gains. Why do more for capital gains? The proponents basically make four arguments. Let's consider them.

First, the bunching argument. The notion here is that capital gains result in long-term appreciation over years but the income is all taxed at once in the year of a disposition, a taxable realization. The interesting aspect of this argument is that bunching is the natural outgrowth of deferral, so the argument involves a complaint about the effect of a tax break, the deferral break, and as such this argument is unpersuasive.

There's an argument in favor of leniency toward capital gains based on inflation: that capital gains are unreal income. But I think equally unreal is the income from a laborer's cost-of-living wage adjustment. For the sake of preserving horizontal equity, we either have to index rates or not do anything at all. It would be inappropriate to single out one subset of income for relief from inflation when all income is equally affected by inflation.

Beyond that, none of the variant methods historically used to benefit capital gains, and I'm including President Bush's current proposal, is at all keyed to inflation. One-, two- or three-year investment properties are benefited fully the same as a property held for one, two or three decades. Proponents for a capital gains tax break neither show a unique detriment to that category of income nor do they even provide a cure.

Third, the lock-in effect. This argument holds that taxation discourages realization events. I suppose taxation discourages me from working, too, but since workers as well as investors get 72 cents, or at least 67 cents on each income dollar after Federal tax, I'll work and I'll continue to make capital investments. Ironically, the 3-year holding period as proposed by the President would have its own lock-in effect if the proponents' premise were in fact valid.

No doubt the prospect of capital gains leniency in the code is having a lock-in effect. Also, an existing provision in the code, section 1014, which steps up the basis of assets transmitted at death, has a profound lock-in effect upon the elderly who hold appreciated investment assets. The lock-in argument is akin to the curve named after economist Arther Laffer. He argued that by lowering rates overall people would work harder and make more money and the Treasury would collect more taxes. Well, my doctor still plays golf on Wednesdays. Harkening back to the pre-1986 act treatment of capital gains, the reality is that sales and realization events with respect to losing investments were encouraged, while appreciating investments would naturally be held for the long term, so you have a lock-in effect there, too.

Finally, capital formation. A number of the witnesses on this panel have spoken specifically to this need. As an aside, I think it deserves mention that qualified deferred compensation opportunities already granted by the code encourage individual savings more than capital gains tax breaks would. If you wanted to key the code to corporate capital formation, I would suggest specifically limiting the lenient treatment to original issues of stock whose investment dollars go directly to the corporate entity for its business purposes. The present code contains a measure that is similarly oriented, section 1244 grants only to original issuees ordinary loss treatment on the sale of stock which otherwise would produce capital loss treatment, which is relatively unfavorably treated in comparison with ordinary losses.

This would put the investment dollars where you presumably want them to go. But if you have capital gains benefits extended to all stock, the effect is to water down that specific incentive and reduce the attainment of its objective.

Finally, revenue loss or revenue gain? I do not expect an increase from the President's proposal. But even if I did, it would not be enough to counterbalance the costs. You have costs of complexity, increased administrative burdens, costs of actual and perceived unfairness in the law. What we have here is a self-assessment system, respect for which we have to foster and protect rather than jeopardize.

This is, after all, a value system that we're talking about.

Should the Federal tax law reflect a national value system that favors, in preference to the fruits of one's personal endeavor, the fruits of one's invested capital? I don't think that's what America is all about.

I appreciate this opportunity to be heard today.

[The statement of Mr. Brown follows:]

STATEMENT OF
WILLIAM J. BROWN, PROFESSOR OF LAW[*]

I. *There should be no difference drawn by Federal tax law between ordinary income and capital gains.*

A. *The complexity which stems from separate classifications of capital gains (loss) and ordinary income (loss) should be eliminated, rather than renewed, in order to simplify the Internal Revenue Code.*

Gains produced by capital appreciation are already tax-favored by virtue of the realization requirement which provides a valuable deferral benefit. Investors with unrealized capital appreciation can extend the advantage of deferral, either through refinancing or nonrecognition transactions. Appreciated-value assets can be used as security for borrowings without taxability. Mergers, consolidations, corporate break-ups, like-kind exchanges, etc. all can be accomplished tax-free -- thereby postponing any taxable realization and enhancing the value of deferral.

By deferring taxability, the realization requirement lowers the real rate of tax on gains. It should also be understood that only realized appreciation in value, over and above one's invested capital, is ever taxed; anyone who characterizes the present rules as "mistreating capital"[1] misapprehends this Constitutional limitation. The fact is that capital gains benefit from tax deferral under current law while the capital invested to produce those gains is absolutely and permanently exempt from income taxation. While the realization requirement stands as a practical necessity for administrative purposes, any grant of additional tax leniency to capital gains would add considerable complexity to the Code.

Adding greater complications to our Federal income tax law is unnecessary and unwise. Because taxes are the means of funding our system of government, it is evident that there must be effective and efficient revenue laws. But complexity compromises efficiency. And when the additional complexity stems from a grant of special tax benefits to the fruits of accumulated capital, it can be expected that perceptions of unfairness in distributing the tax burden nationally will be fostered. This in turn threatens the effectiveness of our essentially self-enforcing Federal income tax. A return to capital gains tax preferences would not only complicate the Code and compromise the delicate balance struck by the 1986 Act, but also weaken the actual and perceived fairness of Federal tax law.

Historically, capital gain and loss rules have been major contributors to complexity in the Revenue Code. This complexity can be attributed to two broad categories of statutory provisions. The first group is made up of special treatment allowances which narrow the tax base. This includes the capital gain definition itself (§ 1221), related capital transaction rules relating to holding period, basis, and the like, as well as the hotch-pot provision (§ 1231). The second group is comprised of safeguard provisions, which stand as barriers attempting to prevent conversions of ordinary income into capital gain. Numerous examples of these intricate rules to block conversions of ordinary income into capital gain are found in today's Code, as vestiges of prior law. They include the depreciation recapture provisions in §§ 1245 and 1250, the treatment of "section 306 stock" under § 306, and collapsible corporations under § 341. Admittedly, depreciation recapture issues might be laid to rest under the President's proposal, by virtue of its excluding "depreciable, depletable, and amortizable property used in the taxpayer's trade or business."[2] On the other hand, §§ 306, 341, and numerous others would have to be made fully operative again under President Bush's plan. The intricacy of these anti-conversion provisions cannot be exaggerated.

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[*] This testimony is presented by the witness in an individual capacity. The views expressed do not necessarily represent those of his employer, the University of Pittsburgh School of Law.

[1] Hearings before the House Committee on Ways and Means on the Federal Tax Treatment of Capital Gains and Losses, 98th Cong., 1st Sess. 323 (1983) (statement of Margaret Cox Sullivan).

Consider, for example, § 341 -- the subject of my remarks over fifteen years ago when I first appeared as a witness before this Committee. The Summary of my remarks on that occasion began, "In 1950 Congress sought to restrict the abusive use of the corporate form, through the so-called 'collapsible corporation' device, as a means of converting ordinary income into capital gains."[3] What had provoked my testimony was a Revenue Ruling interpretation of § 341 which essentially emasculated that provision. My comments were aimed at correcting it. Some ten years later, the minor change which I had recommended be made in the language of § 341 was finally enacted to restore the provision's effectiveness. If there is a lesson to be learned here it is that taxpayer attempts at converting ordinary income into capital gain are inevitable; these tax-reduction efforts put constant pressure upon the anti-conversion provisions, necessitating their regular reinforcement by means of remedial legislation.

The witness who appeared immediately before me fifteen years ago, incidentally, was a tax advisor from Ohio by the name of Hawkins. He cautioned this Committee against listening to me because I was meddling with one of the most complicated provisions in the Code. Mr. Hawkins even suggested that the Committee ask me to read the first sentence of § 341(e), which is over 300 words long. The strange thing is that Mr. Hawkins had no quarrel with the favorable treatment then being accorded to capital gains. Nearing the end of my testimony, I remarked: "If I may be permitted to respond to the question addressed to Mr. Hawkins as to what should be done about capital gains, . . . He said his present position is in support of capital gains as presently favored. I would be in favor of a gradual phasing out of capital gains, because among many other provisions, section 341, as he acknowledged, one of the more complex sections of the Code, would be eliminated if there were no difference between ordinary income and capital gains."[4] I suppose that sometimes those who favor special treatment for capital gains just do not appreciate how very much complexity is inflicted upon the Code as a direct result of this preference.

Coincidentally, not long after that testimony was presented I was engaged in writing a law review article dealing in part with the clash between §§ 351 and 304. Lo and behold, the same Mr. Hawkins had structured a related corporate redemption distribution that included some stock of the distributing corporation. The stock proved to be a magical ingredient, as it served to allow the distributees to report their receipts of cash "boot" in an organizational transfer under § 351 as capital gains.[5] Mr. Hawkins' client thereby enjoyed lenient capital gains taxation rather than the ordinary dividend income taxation which would have resulted under § 304. This simply illustrates one of the myriad, often ingenious ways that ordinary income can be dressed up to look convincingly like a capital gain. The loophole exploited by Mr. Hawkins was eventually closed, but only after several years had passed. (The remedial amendment is found in § 304(b)(3) which takes § 351 out of the fray in appropriate circumstances.) The problem is that any capital gains tax preference is guaranteed to keep provoking conversion efforts, which eventually do succeed in breaking through whatever barriers you might erect.

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[2] *Summary of Revenue Provisions in President Bush's Fiscal Year 1990 Budget Proposal* (JCS 6-89), 3 (March 3, 1989).

[3] *Public Hearings before the Committee On Ways And Means v. House of Representatives, on the subject of general tax reform*, 93rd Cong., 1st Sess. Part 2, 866 (1973).

[4] *Id.* at 868.

The deceptive costuming of ordinary income, in order to pass it off as a capital gain, is inevitable. Whenever you have any preferential rate treatment of capital gains you must therefore undertake continual legislative rebuilding of the barriers against conversions of ordinary income into capital gain; otherwise, each successful deception becomes common practice. That Congress might actually want to undertake this sort of burden by resuscitating the capital gains preference is hard for me to believe. Any legislator who supports the proposal to bring back tax preferences for capital gains had better anticipate the need for remedial amendments to maintain the effectiveness of myriad provisions which are needed to prevent inappropriate conversions of ordinary income.

In contributing substantial complexity to Federal tax law, the capital gains tax preference wreaks its havoc beyond the Internal Revenue Code. In the courts too, complexity abounds from the preferential treatment of capital gains. A prime example is the so-called *Corn Products* Doctrine,[6] which puts a judicial gloss on the entire capital transaction area. This doctrine represents a judicial effort to confine capital gains treatment to those settings which Congress is thought to have had in mind. Unfortunately, taxpayers whipsaw the government by invoking *Corn Products* in order to characterize their losses as ordinary, while distinguishing the doctrine from applying with reference to gain-producing transactions. This naturally forces the government to seek a restrictive interpretation of *Corn Products* in one case and an expansive application of it in the next. Repeated litigation in such a Sisyphus-like setting neither refines the judicial precedents nor serves to clarify the law. It should be appreciated that the *Corn Products* doctrine, as well as the many anti-conversion provisions in the Code, all constitute essentially dead wood under current law. Clearly, they should not be revived. To restore favorable tax treatment for that sub-set of income called capital gains would be the single most complicating feature of the Internal Revenue Code.

To rid the Code of unwarranted complications, Congress should finally repeal the existing provisions dealing with capital gains and losses. Taxpayers today must continue to categorize their capital gains and losses separately from ordinary income and losses, due to § 1211(b). That provision, which limits capital loss deductibility against ordinary income to $3,000 per year, should be repealed. Its repeal would conform the deductibility of capital losses against ordinary income with the current taxation of capital gains as ordinary income. In sum, capital gain (loss) characterizational issues ought be eliminated altogether.

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[5] Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).

[6] Corn Products Refining Co. v. Commissioner, 16 T.C. 395 (1951), aff'd, 215 F.2d 513 (2d Cir. 1954), aff'd on other grounds, 350 U.S. 46 (1955).

B. Arguments for favored capital gains tax treatment are unpersuasive.

It has been argued that because capital gains accrue over a long term, but get bunched into a single tax year when realized, they get taxed at unreasonably higher rates. Of course, this contention has lost much of its force in the face of today's lower rates and reduced number of rate brackets. Indeed, substantial income bunching can now effect a reduction in one's income tax rate, once the 5 percent add-on tax imposed by § 1(g) has run its course. Moreover, the concern over "bunching" relates naturally to gains from investments which have appreciated in value over many years and benefited from tax deferral all the while -- because there has not been any taxable realization of the appreciation. Since bunching results from deferral, the net tax effect is beneficial rather than detrimental.

Even if relief from bunching were considered justifiable, the solution being proposed by President Bush does not meet this need. The rate relief that is proposed would extend to capital assets which have been held only a year or two, or three -- whereupon their holding period becomes "long term."[7] Thus, gains that accrue after just a year or two are to be treated the same as gains from property held for more than ten or twenty years. There is at best a crude relation between lower rates on bunched income and inflation under this scheme. Indexing would be more precise. Also, if tax rates were indexed -- rather than indexing the basis of capital investments -- it would preserve horizontal equity among taxpayers whose incomes were at approximately the same level.

It sometimes has been contended that capital gains only reflect the effects of inflation -- that the income is illusory. The notion that "gain" in such a context is a misnomer, and that there is really no income at all, produced the original compromise of a halfhearted tax on capital gains in 1921. Unfortunately, though, the Internal Revenue Code does not relate to constant-dollar income, as many workers protected against salary erosion by cost-of-living wage adjustments know all too well. These salaried individuals are unable to buy more than before their inflation-compensating raises. Worse, they are taxed more and so have less net after taxes. Given a tax on income, whereby a cost-of-living wage adjustment is subjected to heavier taxation, parity demands that profits from investments in property boosted in value by inflation be likewise taxed as income. It seems inappropriate to excuse the investor of accumulated wealth from exposure to taxation on gains without doing likewise for the wage earner whose purchasing power has not been increased by cost-of-living salary adjustments during an inflationary period. To index gains from capital, without similarly indexing inflated wages from employment, is clearly unfair. Beyond that, any form of indexing that would gear its tax relief to the length of an investor's holding period would carry with it an undesirable lock-in effect.[8] Since it is acknowledged that investment behavior is influenced by taxation, might not the best overall policy be to allow free markets to operate by eliminating artificial differences in tax treatment between ordinary income and capital gains?

Those who plead for capital-gain tax breaks are often the most ardent supporters of a free market. Their manifestly contradictory positions can only be explained by self-interest. Congress should bear in mind, however, that the desire for profit would remain an investment motive even in absence of tax leniency towards capital gains.

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[7] Summary of Revenue Provisions in President Bush's Fiscal Year 1990 Budget Proposal (JCS 6-89), 3 (March 3, 1989).

[8] Internal Revenue Code § 1014 is the biggest lock-in provision of all, as it renders fully exempt from income taxation the paper gains on appreciated property passing at death.

One reason offered for reviving the capital gain (loss) rules in the Code is that people who are either entrepreneurs or venture capitalists look for their rewards to come largely from appreciation in the value of their ownership interests in the corporation they founded, funded, or otherwise assisted. On behalf of these worthy individuals, it is contended that the partially exempt treatment of capital gains realized from their sale of stock is either deserved or needed. When the inside investor does make a profit, however, he or she gets no less taxed than the profits of speculators who in essence have wagered that the stock would go up.

Entrepreneurs and venture capitalists can be saved from the fate of ordinary income taxation without the Government's paying the exorbitant cost of cluttering its Internal Revenue Code with an entire subclassification of income in order to deal with them. A quite specialized grant of tax leniency could be tailored to benefit venture-capital formation by applying only to the original issuee of any corporation's stock.[9] Preferential tax treatment for venture capitalists whose investment dollars actually go into the business (rather than merely being circulated among speculators as exchange transactions generally entail) should be fairly simple to grant, without pervasively complicating the tax law as would the President's program relating to capital transactions. In any case, a public policy that favors venture capitalists and entrepreneurs should not find itself embodied in a law that equally benefits the profits from speculation.

Initial offerings are obviously only a relatively small part of the overall securities market. Most capital gains are realized from corporate stock investments within the broad markets, not new issues that directly feed corporate needs. Much of the activity in publicly traded issues involves institutional investor trading, where taxation is often not a factor at all.[10] Moreover, the business entity itself gets none of the proceeds from the vast bulk of the transactions involving publicly traded securities. Since tax advantages for capital gains were not contrived to promote equity investment, it should come as no surprise that in general they don't. Therefore, any restoration of the preferential tax treatment accorded capital gains would not logically affect venture capital much.

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[9] This suggestion is not altogether novel. Relief from capital loss treatment, as presently granted by I.R.C. § 1244, is illustrative of how Congress might meet capital formation needs without necessarily preserving capital gain and loss rules. See also S. 1666, "The Capital Formation Tax Act of 1983," 98th Cong., 1st Sess. (1983), which proposed "a 10 percent [maximum rate of tax] on issues that are publicly or privately offered through initial stock offerings and that are held for 5 or more years." Explanation by Sen. Chafee in Senate Finance Committee Hearings on Miscellaneous Tax Bills, 98th Cong. 1st Sess. 72 (1983). This Bill was introduced in response to previous hearings on "The Promotion of High Growth Industries and U.S Competitiveness," during which the testimony of venture capitalists were instrumental in shaping such measures. Whereas S.1666 would have added another layer onto the already-voluminous complexities of capital gain(loss) taxation, there is no reason why similar incentive/relief could not be provided in a Revenue Code separately, and apart from any reenactment of pervasive capital gain(loss) rules.

[10] See Statement of Oscar S. Pollock, a limited partner in the New York Stock Exchange member firm of Ingalls & Snyder, in Hearings before the House Committee on Ways and Means on the Federal Tax Treatment of Capital Gains and Losses, 98th Cong., 1st Sess., 331 (1983). See also testimony of Margaret Cox Sullivan, President of Stockholders of America, who also represented the National Association of Investment Clubs ("Eighty percent of the individual investors are long-term stockholders. Less than 20 percent are considered traders.") id., at 323.

As for the impact upon market prices of stock that is outstanding, it bears noting that there were no evident downward adjustments in market prices of publicly traded shares due to the legislative and executive efforts that began in 1969 to bring capital gains into line with ordinary income taxation, nor in 1986 when the 60 percent deduction/exemption for long term capital gains (former § 1202 of the Internal Revenue code of 1954) finally expired.

With the prevalence of institutional investors in today's market, the focus is more upon performance in the near term rather than the long term. Consequently, capital-gains taxation has a diminished bearing upon the market price of investments. Surely the President's objective is not to benefit speculators, but his proposal would do just that. The President's plan to protract the holding period that is requisite to the qualification of a gain as long term, will not serve to deny favored tax treatment to speculators' gains. Unrealized short-term appreciation can be hedged, with little difficulty or cost, until it becomes long term under the President's plan.

The sheer illogic of capital gain (loss) tax rules is manifest: a justification for maintaining capital gain benefits is forwarded for the sake of entrepreneurs, despite that the system equally favors those whose profits are from high-stakes takeover threats; preserve capital gains treatment, it is argued, in order to prevent bunching -- whereas the President's plan would benefit gains that accrue over just a few years equally as much as it would relieve the tax burden on gains realized from selling property held for decades; reduce the lock-in effect by lowering taxes on capital gains and at the same time you create a lock-in effect for three year holding periods under President Bush's proposal. In any case, the complexity which these rules impose upon the Internal Revenue Code cannot be justified.

C. *The case for ordinary treatment of capital gains and losses is persuasive.*

There are several reasons why capital gains should continue to be treated the same as ordinary income. Changes wrought by the Internal Revenue Code of 1986 were profound in their broadening of the tax base and reducing marginal-rate progressivity. To reintroduce special treatment for capital gains would unravel the very fabric of the 1986 Act. The top marginal tax rate applicable to individual income now stands at 33 percent -- already two points below the maximum 35 percent rate at which capital gains were taxable during periods of the preceding President's administration.

In all likelihood, the President's proposal to grant a 100 percent exclusion to gains realized by taxpayers with adjusted gross incomes of less than $20,000 will be perceived by the tax paying populace as illusory. To be sure, major individual investors in nonprivate activity bonds,[11] whose interest is exempt under § 103 and not subject to the alternative minimum tax, might salivate over the prospect of tax-free capital gains. Gifts of appreciated capital assets to children 14 years of age and older (who no longer come within the "kiddie tax") would become a popular means of exploiting the total exclusion benefit for individuals with lower incomes.

The fact remains that the Internal Revenue Code cannot effectively pluralize the benefits of a capital gains tax break, because it takes accumulated capital to play the game and score. On the other hand, if the revival of capital gains tax leniency is widely regarded as primarily benefiting wealthy individuals, then the President's plan will encourage objections to and defections from the self-assessment system upon which we must rely.

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[11] See I.R.C. § 57(a)(5).

Estimates are that about 90 percent of the tax-savings from the § 1202 deduction (more accurately, an exclusion) granted under prior law to long term capital gains was bestowed upon only two percent of our country's taxpayers. An even greater bias in benefits from President Bush's capital gains tax leniency proposal can be projected, because the gap between rich and poor has widened while Federal tax rates pertaining to the highest individual income levels have been dropped drastically. It would be most dangerous to underestimate the negative effects upon self-assessments that are apt to result from such an undemocratic measure.

Capital gains commonly are attributable to a corporate policy of reinvestment of earnings in preference to a distribution of earnings as a dividend. Any substantial difference in tax implications to shareholders -- which depends upon whether the corporation accumulates its earnings to produce capital gains or distributes them as dividends which are ordinary income -- undoubtedly causes distortions in the making of decisions about reinvestment of earnings at the corporate level. Eliminate the false, tax-law distinction between capital gain (loss) and ordinary income (loss), and you allow business factors to control decisions with respect to corporate earnings. Continue to treat capital gain the same as ordinary income and you preserve the free market economy which began to form under the 1986 Code.

Concerns about capital formation and the high level of corporate debt in relation to equity can be addressed by enabling corporations to offer their shareholders a tax-free dividend reinvestment plan. This could be accomplished through enactment of a somewhat expanded version of Internal Revenue Code § 305(e).[12] Any Code allowance for pre-tax reinvestments should of course include a modest cap on the total amount an individual could thereby shield from tax in any year. A plan along these lines would offer an ample inducement to stockholders who wished to defer taxability of dividends and increase their investment in the corporation with pre-tax dollars. It would improve the debt-equity ratios of those corporations offering a dividend-reinvestment plan and encourage savings on the part of their shareholders.

D. *Revenue losses and "lock-in" effects are apt to result from the President's program.*

The investor public is anticipating more favorable capital gains taxation because of Presidential campaign promises as well as the current proposal, which have no doubt induced some postponements of gain-realization events. Although enactment of a favorable capital gains tax rate is apt to produce an initial revenue surge due to a predictable spurt of pent-up realizations (fostered by the anticipated lowering of gain rates), its ultimate effect would likely be a reduction in revenues. Dr. Joseph A. Pechman, a highly regarded economist affiliated with the Brookings Institution, shares this opinion which is also supported by fundamental logic. Especially because the current proposals include provision for a partial exemption of capital gains, which reduces the income tax base rather than merely reducing marginal tax rates, revenue losses will no doubt eventuate. (Tax theoreticians will wince at this distinction, inasmuch as either approach -- a partial exemption or a lower rate of tax -- looks to them like the difference between tweedle dum and tweedle dee.

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[12] Under an addition to the Internal Revenue Code that was enacted as part of the Economic Recovery Tax Act of 1981 (ERTA), qualified public utility companies were given the opportunity to offer shareholders who were to receive cash dividends an option to reinvest the same amount of money in additional shares of stock.

However, the politically astute observer may sense that there is indeed a difference between reducing the tax rate to which income is subject and denying that it is income at all.)

One aspect of the President's proposal, to extend gradually to three years the long-term holding period definition, points up a problem facing any capital gains preference proponent. A three-year holding period will create its own lock-in effect, discouraging sales until the gains become long term. (Set the long-term period much shorter than that, however, and the proposal cannot be said to address the bunching and inflation arguments for justifying special tax treatment.)

Once all hopes for preferential capital gain tax treatment are finally dashed, taxpayers can be expected to return to investment-based decisionmaking about when to realize their gains.[13] With a system of identical tax rates relevant to both earned income and capital gains, there is no greater disincentive to realizing the appreciation from one's capital investment than there is a tax disincentive to working rather than enjoying more time at leisure.

II. *If capital gains are to be taxed differently from ordinary income, there are better approaches than the President's proposals.*

Capital assets are now all too expansively defined in § 1221 as "property." This concept encompasses nearly every type of asset, with only limited exceptions for inventory, copyrights, and the like. A better tack would be to eliminate this open-endedness by defining specifically each narrow category of capital asset on behalf of which there is a convincing case presented for especially lenient tax treatment.

An exception from the capital asset definition under present law is made for depreciable property used in a trade or business. That exception is all but reversed under § 1231 by creating a hotch-pot of so-called quasi capital assets whose disposition can result in capital gains or ordinary losses -- the best of both worlds. By proposing to eliminate all depreciable property used in a trade or business from the capital asset category, the President would apparently favor repeal of § 1231, which is a step in the right direction. Allowing any depreciable property into the capital asset category, regardless of whether or not used in a trade or business, invites conversions of ordinary income into capital gain. Depreciation recapture provisions struggle to renege on this invitation. In doing so, however, they create one of the largest of many intersectional battles that can be seen to stem from the grant of preference rates for capital gains.

By eliminating buildings from the capital asset definition, President Bush moves towards a more narrow definition of capital asset. As recently noted in the Wall Street Journal, however, unfortunate discriminatory implications flow from the President's plan: "industry trade groups and executives warn that real estate would be hurt as investors flee real-estate investments for stocks and other securities."[14] Beyond the market distortions that would be caused under the President's plan, whereby free market investment decision-making is lost, a newfound level of complexity is in the offing. Under the President's restrictively revised definition, undeveloped land is considered as a capital asset. Every owner of undeveloped land who opted to develop the property before selling it would face the vexing question: how much gain accrued as capital gain and how much as ordinary income attributable to development of the property? This issue is virtually identical to that posed by the ill-fated carryover basis ("fresh start") provision added by the Tax Reform Act of 1976, and repealed three years later because of the sheer impossibility of its interpretation and application by taxpayers. The better course would be to exclude all real property from the capital asset definition, in the interests of avoiding confusion and economic unfairness.

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[13] The lock-in effect under § 1014, which still encourages the elderly to retain appreciated capital investments until death so as to secure a step-up in basis for their heirs, should be addressed by making the carryover rule applicable to testamentary as well as inter vivos transfers under § 1015.

[14] Wall Street Journal, March 27, 1989, at B1, col. 1.

In the final analysis, few asset categories seem fit for preferential tax rate benefits. The President's plan eliminates collectables from the capital assets category, which is appropriate despite the income-bunching effect that collectors are even more apt to experience than investors in financial instruments. (As earlier indicated though, bunching only comes about by virtue of the realization requirement -- which works a net benefit in the form of tax deferral.) To the extent a collector's gains merely reflect inflation, no capital gain measure enacted to date would index it anyway.

It can be argued that corporate equity interests, in the form of stock, might legitimately be singled-out as a capital asset category worthy of favorable tax treatment. Granting a lower tax rate to gains from the sale of stock, as proposed by President Bush, would supposedly compensate somewhat for the existing tax-bias towards debt financing by encouraging investments in equity capital. Rather than diluting its impact by offering broad availability (as under the President's proposal), however, there is good reason to restrict the tax benefits from any such measure.

To stimulate an increased supply of new equity capital for corporate America, only original issues of stock ought be entitled to capital gain tax reductions.[15] In the same vein, Congress should consider further limiting availability of any capital gains tax benefits to stock issued by small business corporations.[16]

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[15] The availability of ordinary loss treatment on § 1244 stock under present law is similarly restricted to original issues.

[16] A start on the definition of "small business" can be found in §§ 1244 and 1361(b); the definitional requirements should certainly not be ongoing, as they are in the latter provision, however.

Mr. **Jenkins** [presiding]. Thank you very much, Dr. Brown. I want to express my appreciation to the panel for your testimony. At this time, if there are questions from other members.

Mr. **Archer**. Mr. Chairman, if I may I would like to ask Mr. Bloomfield a question. First, I want to say thank you to all the members of the panel for their contribution.

Mr. Bloomfield, it is my understanding that the basis for the Joint Committee's revenue estimates on capital gains is founded on the assumption that in order for the administration's proposal to be revenue neutral over the long term, that there would have to be a permanent doubling of the volume of transactions. By permanent, I mean ad infinitum into the future. Otherwise, in the long term there would be a negative impact on revenue. I wonder if you would comment on that because the basis on which these projections are made become extremely important as to which is the correct and which is not the correct ultimate estimate.

Mr. **Bloomfield**. Mr. Archer, as we all are aware, the revenue estimating aspect of capital gains is one of the most difficult and complicated matters that face economists. There is a difference of opinion between the Joint Committee and the Treasury on the revenue question and the difference of opinion is not a minor one. It's a difference of opinion of about $40 billion over a 4-year period.

At the crux of the difference is the Joint Committee analysis, as you indicated, that for the administration's proposal to be a revenue gainer over the long run there has to be a doubling of realizations. I would like to respond to that in three ways.

First the Joint Committee in recent testimony by committee chief of staff, Ron Pearlman, pointed out that there is no historical evidence to sustain a doubling of realizations in a short period of time. Specifically, the Joint Committee criticized the analysis done by Dr. Martin Feldstein of Harvard University of the 1978 capital gains tax cut which indicated that there would be a tripling of realizations. The Joint Committee said that the data do not support that contention.

What Dr. Feldstein, again focusing on the historical aspect, is suggesting is that there would be a tremendous increase in capital gains realizations and a tripling of realizations for upper income taxpayers. If upper income taxpayers, obviously, increase their realizations, you get more revenue than you do if lower income individuals increase their realizations. The data from the IRS very specifically indicate that there was a tripling of realizations for taxpayers with incomes of $100,000 and above in the first year from 1978 to 1979. The question is: Does this continue long-term? The IRS data 5 years later for that class indicates there was not only a tripling, but that realizations increased fivefold and continued to increase. My first response to the Joint Committee is there is sufficient historical evidence to justify a substantial increase in realizations resulting from a reduction in the capital gains tax to 15-percent.

The second issue that the Joint Committee and the Treasury debate is the level of behavioral response. I would like to preface my response to that by indicating that the 15-percent approach actually predated the involvement of President George Bush.

As you may recall, exactly 2 years ago this committee held hearings on some recent research done in academia which suggested that the revenue maximizing rate for capital gains, according to the bulk of academic studies, was between 9 and 21 percent. That is why some members of this committee proposed a 15-percent capital gains rate and that, I believe, is also the basis of the President's endorsement of a 15-percent capital gains rate. It has serious and substantial academic research behind it.

For a tax cut to raise revenue, the estimate of the elasticity, or behavioral response, must be greater than 1.0. Both the Joint Committee and the Treasury, for the short term, determined the elasticity, on behavioral response to the 15-percent capital gains tax rate, to be 1.2. That is why you have a revenue gain according to both in the short term.

In the long term, the Joint Committee suggests that the elasticity is actually 0.7 and the Treasury said it is 0.9. With a Treasury elasticity of 0.9, which is less than one, you actually do have a revenue gain in the long term because most of the revenue from capital gain taxes comes from upper income people who respond to a greater extent to a capital gains tax cut.

The Joint Committee's long term elasticity of 0.7, I believe and the evidence suggests, is in the bottom range of all the academic studies as opposed to the Treasury's elasticity of 0.9 which is in the middle.

Finally, Mr. Archer, I'd like to comment on the recent Joint Committee analysis of the revenue maximizing rate for capital gains. The Joint Committee analyzed a 15-, 20-, and 25-percent rate for all assets. They indicated the long-term revenue impact of a 25-percent rate would a loss of $400 million a year. If that is true, perhaps a capital gains tax rate of 17, 18, or 19 percent applied to the assets specified in the President's proposal, which might be a revenue raiser according to Joint Committee estimates.

Finally, Mr. Chairman, the third aspect of the Joint Committee's analysis relates to the fact that, obviously, you to have a behavioral response but you have to have a volume of unrealized capital gains. Are there enough unrealized capital gains out there today and tomorrow to sustain that type of increased revenue?

Again, I think the answer is yes. There are now $4 trillion of unrealized capital gains. If you exempt residential housing, there are $2 trillion of unrealized capital gains. You also have increases in unrealized capital gains to the tune of $360 billion a year, whereas last year the total realizations from capital gains were in the range of $130 billion.

So, Mr. Chairman, I suggest that there is substantial evidence, even though it will never end the debate, that the President's proposal is a revenue raiser and the Treasury's documentation on that can find a lot of historical, theoretical, and other support.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman. I thank all the panelists for their testimony.

Doctor Brown, a quick question on capital gains and what happens in other countries. How is it or why is it that these countries seemingly all have lower capital gains than we do and particularly those in the Pacific Rim who are doing very, very well. Why would you oppose capital gains having seen what has happened in the past in this country when we have had capital gain reductions and the low capital gains among our competitors?

Mr. BROWN. Well, first of all, I think you have to take it within the context of the entire revenue measures in the nations that you're going to compare with. Mr. Caufield started his remarks by observing the decline in U.S. economic stature around the world. It's interesting to note that that did not come into effect since 1986. It was in the making when capital gains rates were very lenient in this country, when there was a 60-percent exempt provision, Section 1202, then in the code. I think that to suggest there is that profound an impact——

Mr. SUNDQUIST. Why are the other countries doing it then if it is so bad? Why do we have the growth in Pacific Rim countries if it is so bad? Why is Japan doing so well?

Mr. BROWN. To state the obvious, other factors are at work.

Mr. SUNDQUIST. You can state the obvious in this country and say other factors are at work, however the information that you have shared with us showed that capital gains differential has been beneficial at certain times. Is this true?

Mr. BROWN. Well, the fact is that during the decline that Mr. Caufield alluded to, our country has had quite lenient treatment of capital gains. So, does that not suggest to you that when we have lenient treatment and we decline—I don't want to suggest that we decline because of the lenient treatment, but I want you to think about the fact that the other countries that you're alluding to, the Pacific Rim and others that have done well, may not be able to attribute that success to their capital gains policy. There are other factors at work.

Mr. SUNDQUIST. Perhaps it is also true though when we are in a decline maybe there are other factors at work and not the capital gains. Maybe it is despite that. Would any of the other panelists care to comment on what is happening around the world with regard to capital gains rates?

Mr. CAUFIELD. I'll address that briefly. I think clearly the matter of the losses of U.S. industry to foreign competition, particularly Japan and other Pacific Rim countries, is a function of a lot of things but importantly, and probably most importantly, is the cost of capital and the cost of capital has been cheaper in Japan for many years and a lower capital gains rate alone is not going to stem that but a lower capital gains rate will have a significant effect on that and when you're in this situation you have to take where we are at today as where we are—or let's say where we were before the Tax Reform Act and then, by making the changes that were made, clearly you're going to give people an incentive to put their money into things that are shorter term and lower risk. If you change your tax structure in a certain way to encourage certain kinds of behavior, you can't be surprised when that happens and the results can hardly be beneficial for United States companies that are competing with the Japanese.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

Mr. BROWN. Could I follow up on that just for a moment? I don't disagree with anything Mr. Caufield said in respect of the cost of capital, but a much more profound impact on the cost of capital is felt from accelerating the rate at which depreciation of capital investments can be claimed, rather than putting the carrot down the road with regard to a capital gains tax break.

If you're going to try and encourage capital formation, you can tinker with the rates of depreciation. You can foster increased participation in qualified deferred compensation plans. And you can extend, if you wish, a limited break in the nature of a capital gains tax break to original issuees of stock. There you get capital formation. If you put the benefit that you extend to original issuees in the context of what we have always had in this country, capital gains tax benefits to anyone who trades stock generally—it tends to water down the inducement. I think the problem is targeting the objective, and fashioning the law in a way that only extends its benefits to a limited segment that you're trying to affect behavior in.

Mr. SUNDQUIST. Thank you.

Chairman ROSTENKOWSKI. If there are no further questions——

Mr. ARCHER. Mr. Chairman, if I may, I would like to follow up for just one moment on this thesis. Most everyone in the United States agrees that we are short of capital savings. I have not heard anybody say that one of the strengths of the United States is the capital savings of this Nation. If you put it by tenet in the first reader, the result of capital savings is capital assets and capital formation and investments.

The purpose for capital saving is to have investments that produce a higher standard of living for everybody, I believe. I think most everybody would agree.

I would like to ask you gentlemen what percent of capital sales is reinvested in other capital assets, in other capital formation, and what percent is spun off into consumption?

Mr. BROWN. This is a good time to defer to Mr. Bloomfield.

Mr. BLOOMFIELD. I appreciate the deferral. Mr. Archer, I'd like to get back to you on that.

Mr. ARCHER. I am going to make another point in a minute after I get the answer to this question.

Mr. BLOOMFIELD. I will say I can respond to some extent on that by commenting on some recent work by Dr. George Hatsopolous, the CEO of ThermoElectron Corp., chairman of the Boston Federal Reserve Bank who I understand will be testifying before you on the savings hearings next week. He did some work with Professors James Poterba and Paul Krugman at MIT which discussed what economists call the propensity to consume. Dr. Hatsopolous was talking about the effect of cash takeovers on inventory cash-flow. He notes in his appendix that the propensity to consume increases dramatically to I believe it's 50 percent—I don't have the numbers in front of me—if you have a takeover which generates cash for stockholders and the fellow gets the cash from the forced realization. Dr. Hatsopolous compares that to the propensity to consume out of unrealized gain which is what you have with capital gains per se where you're not forced to reinvest. You may want to ask him to pursue this point when he testifies before the committee. I should however stress that the economic literature strongly suggests that the propensity to save—or reinvest in response to Mr. Archer's question—is very high for upper income taxpayers.

[The following was subsequently received:]

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Hon. Ed Zschau
former Member of Congress

May 1, 1989

Honorable Bill Archer
U.S. House of Representatives
1135 Longworth Office Building
Washington, D.C. 20515

Dear Bill:

I would like to respond further to the question you raised during the Ways and Means Committee hearing on April 13, on the President's capital gains tax proposal. Specifically, you asked me what percent of capital sales are reinvested in other assets and what percent is consumed?

My chief economist, Margo Thorning, investigated the question. There do not appear to be any studies which address precisely your question. However, there are data and empirical studies related to the question you asked which may permit a "best quess" of the share of realized gains which will be reinvested.

First, the 1983 Survey of Consumer Finances by the Federal Reserve Board (Fed) demonstrates that high-income families, as would be expected, own substantially more stock and have greater net worth than do low-income families (see Table 6 of the enclosed Fed report of March 1986 and Table 7 of the December 1984 Fed study). Thus, one could conclude that high-income families may have a much greater propensity to save out of ordinary income, and out of realized capital gains as well, than do low-income families. Since the President's capital gains proposal is targeted toward corporate equities, and since upper income families own a large portion of corporate stock, it seems reasonable to conclude that the majority of realized capital gains would be reinvested.

Second, while there are no empirical studies which specifically address your question, Margo did find a recent analysis by Patric Hendershott and Joe Peak, "Household Saving: An Econometric Investigation" which has some relevance. The Hendershott/Peak study examined the impact of unrealized capital gains on household saving. The authors conclude that a $1 increase in unrealized capital gains causes a drop in household saving in the range of 2 to 16 cents.

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Abstracting from the Hendershott/Peak study, one can surmise that a portion of realized capital gains may be spent for consumption since one reason for saving is to be able to consume in the future. However, given the fact that most corporate equities are held by upper-income individuals, whose propensity to save is much higher than most of low- income individuals, it seems plausible that they will save the majority of any realized capital gains, particularly since they may have realized the gain in order to invest in a more attractive asset.

Please do not hesitate to call or have your staff call me or Dr. Thorning, if we can be of further assistance.

Best regards,

Mark Bloomfield

MB/ks
Enclosure

cc: Robert Leonard

[THE ATTACHMENTS TO THIS LETTER ARE BEING MAINTAINED IN THE COMMITTEE FILES.]

Mr. ARCHER. Well, it seems clear to me that the overwhelming percentage of the money that results from the sale of a capital asset is going to be put back into another capital asset in contrast to ordinary income, the majority of which is almost all going to be put into consumption.

If the purpose of increased savings rate in this country is to have additional capital investment, then we have got two things about which to be concerned. One is how do we increase our savings rate. Second, how do we protect the pool of capital that is already out there? This is where I would argue a little with Doctor Brown because if we are going to protect the pool of capital that is out there, we have to reduce the siphon tube of the Federal Government pulling out money into the general treasury to be spent on consumption primarily from the sale of capital assets.

We are reducing the pool of capital every single month by the tax on capital gains and at the same time we are saying that we need more capital savings and we have to find some other incentive out here to increase savings on the other hand. There is a great dispute within the academic community about whether all of the incentives we think about to increase saving are really going to result in a net aggregate increase in savings or not. It seems to me that the first thing we should be trying to do is to protect the nucleus and the pool of capital that is already out there and has been saved in the past. We should not be robbing that from future generations by putting it into the Federal Treasury to use for foreign aid and all other kinds of current expenditures.

I agree that capital savings can also be generated internally by depreciation allowances and other things, too, and that is a major source of potential capital savings for this country but you are talking there about how can we increase and I'm talking about how can we protect what is already out there.

Thank you very much. If you want to respond and the Chairman permits, that is fine.

Chairman ROSTENKOWSKI. Go ahead, Dr. Brown. You've got 1 minute.

Mr. BROWN. It seems to me that you actually want to increase the amount of your seed corn rather than try and preserve what's already invested. I agree with you that most——

Mr. ARCHER. If you are stealing from your existing seed corn, you've got to increase that much more.

Mr. BROWN. Right. The Federal Government needs *x* dollars on which to run. The question is where do you collect it? Do you collect it from wages? Do you collect it from the realizations of gains from the already invested capital? I agree with you that most gains from already invested capital, after the tax bite is paid, are reinvested in capital appreciating assets, we hope.

But, interestingly, the behavior patterns of saving in this country did not significantly change as a consequence of the significantly lower rates under the 1986 act.

Chairman ROSTENKOWSKI. That's true.

Mr. ARCHER. But the point is that the lower rates left more of the capital pool available.

Mr. BROWN. But people consume it. They don't save it.

Mr. ARCHER. You just admitted that the money from the sale of capital assets is reinvested in capital assets. The greater percentage which you take as taxes, the less you have in a capital pool in this country.

Chairman ROSTENKOWSKI. Mr. Levin.

Mr. LEVIN. Just a quick question before you call the next panel, Mr. Chairman. From those who are proponents of the President's proposal, let me just be sure I understand your position. Of course, distributional effects aren't the only factor here. There are others but is it your position that when you get done with this change, if it were effectuated, that the proportion of the overall tax load in this country borne by families with income of $100,000 and above would be the same as before the change was made? Do you state it that boldly? Is that your position?

Mr. BROWN. Mr. Levin, taxes paid by income class, taxes paid, will increase marginally by upper income people according to Treasury tables. The table is in my testimony and also academic. Now it is true the way it was phrased on the TV the other day, are you saying that a guy is getting a $30,000 tax break if he earns $200,000, is that fair that somebody is getting a $30,000 tax break under the President's proposal. My response to that is yes, he is keeping more of his own but to keep more of his own he has to pay a tool to the Government. He will be paying more taxes so the Government gets more revenue which it otherwise would not have gotten.

Mr. LEVIN. Just boil it down and then maybe Doctor Brown can say yes or not, because you've all seen the Joint Tax Committee study and it concludes that 60 percent of the tax change would go to families earning $200,000 and above.

Mr. BROWN. Tax burden relief but not taxes paid.

Mr. LEVIN. All right, but when you add all the dollars that come into the Treasury after the change, your position is that for a variety of reasons that the percentage of taxes of that revenue, tax revenue paid by families $100,000 and above, would be the same or lower if there were the change recommended by the President. That's your testimony?

Mr. BROWN. Yes. It would be a 9.2-percent increase in capital gains taxes paid by tax periods over $50,000 of adjusted gross income and a 3-percent reduction in capital gains taxes paid.

Mr. LEVIN. But you're not answering my question. I'm asking you when you put all the revenues together, we now know how much is paid for by families with $100,000 and above and $200,000 above. Assume this tax change. Would those families making $100,000 and above have a larger, the same or smaller proportion of payment of the tax revenues of the United States.

Mr. BROWN. Larger.

Mr. LEVIN. What?

Mr. BROWN. Larger.

Mr. CAUFIELD. I think in fact that's true but the explanation is of course that the reason it gets larger is that they sell more——

Mr. LEVIN. I understand that and I know this is a matter of academic work, if not speculation.

Mr. CAUFIELD. They pay more but they're better off.

Mr. LEVIN. OK. And you would say?

Mr. **Kertzman.** What I would say is I would agree with the others here and I would also say that every time a capital gain is realized on a job producing investment, the kind of investment that went into my company, we should celebrate as a nation.

Mr. **Levin.** All right, Dr. Brown.

Mr. **Brown.** Well, the benefits of capital gains tax breaks will inure primarily to the wealthy. That fact, whether it contradicts what my fellow panelists have said or not, I think can not be disputed.

Mr. **Levin.** Thank you.

Chairman **Rostenkowski.** Mr. Pease.

Mr. **Pease.** Thank you very much, Mr. Chairman. I was very glad for that last statement which certainly is a correct one. A lot of people say, and I think the answers come out in this panel in response to the questions from Mr. Levin, a lot of people carefully say, who support the President's program, that if you have a lower capital gains rate higher income people will pay more taxes. I think that's fair enough.

If, under a 28-percent top rate, realizations for a given individual are $100,000, then that person pays $28,000 in tax. If, under a lower capital gains rate, more realizations occur for the same person, say twice as many, and person pays 15-percent on $200,000 of realizations then the person pays $30,000 which is more taxes. However, the person's effective tax rate on those realizations drops from 28 to 15. Is everybody in agreement on that?

Mr. **Bloomfield.** No.

Mr. **Pease.** All right. Tell me why not.

Mr. **Bloomfield.** Mr. Pease, I think it is fair to characterize the capital gains tax for moderate- and upper-income people as zero, not 28, not 15 and not 33. The reason for it is that the capital gains tax is a voluntary tax. People can choose not to pay the tax. There are anecdotal and other reasons to suggest they're locked in, so what you're doing with a small class of taxpayers is taking them from a tax rate of zero to a tax rate of 15 percent. I do not dispute at all the basic point that you're making. That is to say, an upper-income person will keep more of his gain at a lower tax rate but, at the same time I'm focusing on the traditional Joint Committee analysis which evaluates taxes paid and would show that taxes paid by income classes under a 15-percent capital gains tax rate will marginally become more progressive.

Mr. **Pease.** This is really—I don't know how to describe it. What you're doing is comparing the 15-percent rate that people will pay on their capital gains if they realize it with the zero percent they will pay if they hold stock and don't sell it at all. Is that what you're telling me?

Mr. **Bloomfield.** We're talking about what the real tax on capital gains is. People may choose not to realize capital gains at all at high tax rates so the Government doesn't get any revenue.

Mr. **Pease.** And the people don't get any income.

Mr. **Bloomfield.** That's right but your question, I believe, is What is the impact of the tax proposal on Government receipts by income class?

Mr. **Pease.** No, no, that's not my question. The question is what is the impact on individuals and the statement was just made. Mr.

Brown is certainly correct that there's no escaping the fact that the preponderance of the benefit of a capital gains reduction goes to high income people.

Well, I want to move on because I'm just about out of time. I have been a very vocal opponent of the President's capital gains proposal and I intend to continue that opposition but for Mr. Caufield, in particular, and for Mr. Kertzman, are you the entrepreneur?

Mr. **Kertzman**. I am.

Mr. **Pease**. For the two of you, I'd just like to state for the record here in open committee room that I don't have any real problem with capital gains treatment for venture capital. I'm an admirer of venture capital. I think it does a lot of good things in our society. It does create jobs. I think, Mr. Kertzman, you correctly stated one of the benefits of a lower capital gains rate and that is you can attract people to work for your firm for the prospect of future capital gains rather than present salary. I have no problem with that at all.

My chief problem with the capital gains proposal is that we get so little bang for the buck, that is, venture capital transactions are a tiny, tiny percentage of all stock sales and venture capital provided by individuals is less than 20 percent of the amount of venture capital so it seems to me, for other reasons, that we are running the risk of a very large revenue loss and making the Tax Code considerably less progressive in order to get a very, very small result and that's why I'm opposed to the proposal, not because of any lack of appreciation for the role of venture capital in our society. Thank you.

Chairman **Rostenkowski**. If there are no further questions, gentlemen, thank you for joining us.

Ladies and gentlemen, welcome to the committee. You all have been familiarized with our rules. Give us your statement and try to do that within a 5-minute range if you can. We don't tar and feather you if you go over a little bit, but if you have a long statement you'd like to have included in the record and summarize your statement, you're welcome to do that. After you've concluded your statement, we'll get into a discussion with the members of the committee.

Mr. Perlman, if you'd like to begin your testimony, the committee is ready to receive it.

STATEMENT OF MARTIN PERLMAN, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS AND PRESIDENT, PERL HOMES

Mr. **Perlman**. Thank you, Mr. Chairman. Mr. Chairman, and members of the committee I am Martin Perlman, first vice president of the National Association of Home Builders, and president of Perl Homes in Houston, TX.

I am pleased to be here this morning to represent the National Association of Home Builders' 155,000 member firms and the 8 million employees who work for these firms in expressing our association's views on the revenue proposals in the administration's fiscal year 1990 budget.

The National Association of Home Builders applauds you for conducting this timely hearing, and congratulates you, the Congress and the administration, for your rapid consideration of the fiscal year 1990 budget. All American businessmen are aware of the grave budgetary problems facing our nation. We understand the difficulty you will encounter. Our comments today focus on the proposal to reinstitute a favorable tax rate differential on the sale of capital assets. While this issue may only be a small piece of the budget proposal, its outcome will have major economic ramifications.

We applaud President Bush for seeking to restore the capital gains incentive that was repealed by the Tax Reform Act of 1986. However, President Bush's proposal in its current form is flawed because it does not apply to depreciable real property, thus the National Association of Home Builders cannot support the proposal in its current form.

From 1921 until the Tax Reform Act of 1986, the tax burden imposed on the sale of capital assets was lower than that imposed on ordinary income. The policy reasons for this treatment were twofold: First, Congress chose to differentiate between the occasional sale of investment properties and reoccurring gain from the sale of inventory or other income-producing activities; second, Congress saw the favored tax status as an incentive to investment.

This latter consideration evolved over time to become the foremost rationale for capital gains treatment. Although the exact formula for capital gains taxation varied over time, most recently capital gains was afforded a 60-percent exclusion from taxation. The remaining 40 percent was taxed as ordinary income.

In an effort to fund the tax rate decreases enacted by the 1986 act, the capital gains exclusion was eliminated.

In his budget submission on February 9, 1989, President Bush called for the reestablishment of a capital gains rate differential to spur investment. The President's proposal specifically excludes depreciable real property and timber, though raw land is included. Since that time, several bills have been introduced on this issue. Their content runs the gamut from complete exclusion of all capital assets to encouraging a retention of current law. Clearly, the issue has captured the attention of both the business community and the Congress.

Few would deny the close link between housing policy and tax policy. Changes in the tax code can dramatically affect investment patterns and alter long range real estate and housing development decisions. For evidence of this, one only needs to look at the impact the 1986 Tax Act has had on the production of low- and moderate-income housing.

As the debate begins on this crucial issue, consideration must be given to the economic consequences which would result if tax incentives are granted one industry but denied another. All industries are competitors in the search for investors. The 1986 act, while abolishing the capital gains differential across the board, made other adverse changes in the tax treatment of housing. These changes resulted in a severe decline in housing investment.

For example, 1987 showed a drop-off of nearly 50 percent in rental housing construction compared to 1985 and 1986. From a housing policy prospective, this could not have occurred at a worse time. In many areas of the country, the Nation's rental housing stock is in short supply and in a state of disrepair. Unfortunately, the impact of this situation is felt most strongly by those who can afford it least, the Nation's poor.

While real estate and housing was not the only industry to be harmed as a result of the Tax Reform Act, it was the hardest hit. Until only recently, the nonreal estate economy has prospered while housing affordability has worsened. Production, especially for desperately needed low- and moderate-income units continues to lag.

The President's proposal to allow favored tax treatment to other industries, while denying it to housing would exacerbate this situation by luring more investment dollars away from housing.

The National Association of Home Builders agrees with the President's notion that favored capital gains tax treatment would encourage investment. We are concerned, however, that if enacted as proposed by the President, a strong disincentive to invest in housing will result.

I thank you for the opportunity to appear here today, and ask that my full written statement be included in the record. I am prepared to answer any questions you may have about my statement at the end of this panel.

Mr. PICKLE [presiding]. Thank you Mr. Perlman.

[The statement of Mr. Perlman follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
WAYS AND MEANS COMMITTEE

on

REVENUE PROPOSALS IN THE ADMINISTRATION'S FY'90 BUDGET PROPOSAL

APRIL 13, 1989

Mr. Chairman and Members of the Committee, I am Martin Perlman, First Vice President of the National Association of Home Builders (NAHB) and President of Perl Homes in Houston, Texas. I am pleased to be here this morning to represent NAHB's 155,000 member firms, and the eight million employees who work for these firms, in expressing the Association's views on the revenue proposals in the Administration's FY'90 budget.

The National Association of Home Builders applauds you for conducting this timely hearing and congratulates you, the Congress, and the Administration for your rapid consideration of the fiscal year 1990 Budget. All American businessmen are aware of the grave budgetary problems facing our nation. We understand the difficulty you will encounter. Our comments today focus on the proposal to reinstitute a favorable tax rate differential on the sale of capital assets. While this issue may be only a small piece of the budget puzzle, its outcome will have major economic ramifications. We applaud President Bush for seeking to restore the capital gains incentive that was repealed by the Tax Reform Act of 1986. However, President Bush's proposal in its current form is flawed because it does not apply to depreciable real property. Thus, NAHB cannot support the proposal in its current form.

BACKGROUND

From 1921, until the Tax Reform Act of 1986, the tax burden imposed on the sale of capital assets was lower than that imposed on ordinary income. The policy reasons for this treatment were two fold. First, Congress chose to differentiate between the occasional sale of investment property and recurring gain from sale of inventory or other income producing activities. Secondly, Congress saw the favored tax status as an incentive to investment. This latter consideration evolved over time to become the foremost rationale behind capital gains treatment.

In 1942, Congress adopted the position defining depreciable property used in a trade or business as a capital asset. This position had been retained, though slightly modified, until the 1986 Act.

Although the exact formula for capital gains taxation varied over time, most recently, capital gains was afforded a 60 percent exclusion from taxation (the remaining 40 percent was taxed as ordinary income). In an effort to increase federal revenues so as to fund the tax rate decreases enacted by the Tax Reform Act of 1986, the 60 percent exclusion was eliminated.

In his budget submission on February 9, 1989, President Bush called for the reestablishment of a capital gains rate differential to spur investment. The President's proposal specifically excludes depreciable real property and timber, though raw land is included. Since that time, 10 separate bills have been introduced on this issue (H.R.461, H.R.1029, H.R.4542, H.R.1599, H.R.1601, H.Con.Res.42, S.171, S.348, S.411 and S.511). Their content runs the gamut from complete exclusion for all capital assets to encouraging a retention of current law. Clearly the issue has captured the attention of both the business community and Congress.

TAX POLICY AND HOUSING

Few would deny the inextricable link between housing policy and tax policy. Changes in the Tax Code can dramatically effect investment patterns, and alter long range real estate and housing development decisions. For evidence of this, one needs only to look at the impact the 1986 Tax Act has had on the production of low- and moderate-income housing.

Recently, legislation was introduced that would create a Select Committee on Housing and Tax Policy. NAHB urges serious consideration of H.Res.113.

There are many tax provisions that serve as the cornerstone of housing policy. The first and foremost tax incentive for housing is the home mortgage interest deduction. NAHB urges this committee to retain the mortgage interest deduction in its present form and to remove the $1 million cap currently limiting it. We would like to point out that H.Con.Res. 37 calling for no further erosion of the mortgage interest deduction has been co-sponsored by over one-half of the Members of the House.

There are several housing related tax issues which this committee will debate during this Congress. NAHB asks that careful consideration be given to the developing housing affordability crisis and that Congress enact:

- H.R.118 -- which would restore prior law treatment to contributions-in-aid of construction made to utility companies;
- H.R.1200 --which would extend the mortgage revenue bond program for three years;
- H.R.796 -- and other legislation which would extend and make improvements to the low income housing tax credit; and
- H.R.6 -- and other legislation which would create urban and rural enterprise zones.

IMPROVED REAL ESTATE SHOULD BE INCLUDED IN THE DEFINITION OF CAPITAL ASSETS

As the debate begins on this crucial issue, consideration must be given to the economic consequences which would result if tax incentives are granted one industry but denied another. All industries are competitors in the search for investors. The 1986 Tax Reform Act, while abolishing the capital gains differential across the board, made other substantial changes in the tax treatment of housing, specifically:

- Depreciation periods were lengthened;
- The deduction for passive losses was eliminated
- accounting methods were altered;
- Rapid amortization of low-income housing expenses was eliminated;
- Severe limitations were placed on the real estate at-risk exceptions; and
- The tax exclusion for contributions-in-aid of construction was repealed.

Taken alone, any of these changes would have had an impact on housing. Their combined enactment resulted in a severe decline in housing investment. For example, 1987 showed a drop off of nearly 50 percent in rental housing construction compared to 1985 and 1986.

While 1988 statistics are not yet available, preliminary estimates indicate little, if any growth was experienced. From a housing policy perspective, this could not have occurred at a worse time. In many areas of the country, the nations's rental housing stock is in short supply and in a state of despair. Unfortunately the impact of this situation is felt most strongly by those who can afford it the least; the nation's poor.

While real estate and housing was not the only industry to be harmed as a result of the Tax Reform Act, it was the hardest hit. Until only recently the non-real estate economy has prospered, while housing affordability has worsened. Production, especially of desperately needed low and moderate income units, continues to lag. Approximately 16 million renter households pay more than 30 percent of their income for rent. Homeownership rates have been falling, particularly among young households, and the growing problem of homelessness continues to be an embarrassment to our industry and country. The President's proposal to allow favored tax treatment to other industries would only exacerbate this situation by luring more investment dollars away from housing.

Given the fact that inflation enhances the value of favorable capital gains treatment, and that we are experiencing continually higher rates of inflation, this unbalanced situation has the potential to worsen.

TIMBER SHOULD BE DEFINED AS A CAPITAL ASSET

The President's proposal also excludes timber from the definition of a qualified capital asset. Approximately 10 percent of the cost of single-family residences and 5 percent of the cost of multifamily residences can be attributed to timber costs. The taxation of timber as ordinary income has driven up its price, causing a rise in home prices as well.

Further, investment in timber production is discouraged by granting favorable capital gains treatment to other types of investment.

RECAPTURE OF DEPRECIATION

In 1964, Internal Revenue Code section 1250, which treated as ordinary income that portion of the gain on sale of real property which was equivalent to the amount of prior depreciation, was enacted. This recapture of depreciation was structured so as to make allowance for actual property appreciation. Thus, the amount of recapture was limited to the excess of accelerated over straight-line depreciation. Since the Tax Reform Act of 1986 repealed the capital gains exclusion and required straight-line depreciation for buildings, recapture is not currently an issue.

Thus, if capital gains treatment is restored for buildings, there would be no "excess" depreciation to be recaptured on buildings placed in service after 1986.

ALLOCATION OF LAND AND BUILDING COSTS

Since the President's proposal would grant capital gains treatment to the land on which a structure is built while denying it to the structure itself, it would create a strong incentive for taxpayers to allocate disproportionately the value of their property. This situation would be exceedingly difficult for the IRS to monitor. It was partially in recognition of this fact that in 1942 Congress opted to tax buildings in the same manner as the land. Nothing has happened since that time to make such allocation or monitoring easier.

CONCLUSION

The National Association of Home Builders agrees with the President's notion that favorable capital gains tax treatment would encourage investment. We are concerned however, that if reenacted as proposed by the President, a strong disincentive to invest in housing will result.

One of the goals of the Tax Reform Act of 1986 was to create a level playing field so that investment decisions would be based on economic return, not upon tax consequences. If this goal is to be abandoned and the tax code is to be reinjected into the investment process, then it must be done in such a way as to avoid exacerbating our nation's housing affordability crisis. Either housing should be included in the definition of capital asset, or current law should be retained.

Moreover, we urge a careful and determined look at establishing a Select Committee to better address one of the basic necessities of life -- shelter -- in a coordinated and comprehensive approach.

Mr. PICKLE. Now, we will recognize Mr. Flynn.

STATEMENT OF NORMAN D. FLYNN, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS

Mr. FLYNN. Yes: my name is Norman Flynn. I am a broker from Madison, WI. I am currently president-elect of the National Association of Realtors. We have 800,000 members in the real estate industry covering the full gamut of real estate business activities.

I am pleased that you would hold these hearings and we have submitted for the record written testimony. I'd like to now verbally highlight some of that testimony and add some additional information to it.

We favor the capital gains treatment that we had before the 1986 Tax Reform Act. We are opposed to the administration's proposal, especially because it does not include depreciable real estate.

We do that for a number of reasons. First, tables 1, 2, and 3 in our written proposal, present the distribution of people's incomes and those who would be benefiting by capital gains treatment. The major criticism of capital gains is that it is regressive, that those people that have the highest income and those in upper-income households had the greatest benefit from capital gains treatment.

In fact, if you look at those tables and charts, if you take the upper 1 percent of income people earning $150,000 or more, they have 12 percent of the total income, and they own 45 percent of the stocks and 43 percent of the bonds. So the upper 1 percent would be the people who would gain the most if you have capital gains treatment which just applies to stocks and bonds and those kinds of equities.

If you take those 33 percent, the next 33 percent of income, that have incomes between $30,000 and $150,000, they represent 57 percent of the income, and they own 38 or 43 percent of the stocks and bonds. In total, the upper third of income then control about 85 percent of the stocks and bonds, and the bottom two-thirds only have about 15 percent of the stocks and bonds. So indeed if capital gains only applies to stocks and bonds, it is regressive.

Now, if you apply nonhome real estate to that and look at what happens to the distribution, you discover that in the nonhome real estate the people, that 1 percent, owns 12 percent of the income, they only own 16 percent of the real estate, nonhome real estate.

The next group which has 57 percent of the income owns 52 percent of the real estate, and the bottom 33 percent or 31 percent own 32 percent of it.

So indeed if you look at the distribution of the income and add the nonhome real estate and apply capital gains to both of them, you do away with some of the regressivity, you make it more progressive, and clearly you make it more equitable.

So we believe that if you're going to look at capital gains, and we believe it's appropriate that you do look at capital gains, and if you add the real estate component to it, the nonhome real estate component to it, you then have equity, or more equity and less regressivity. So we encourage you when you're examining that, to do that.

The second point I'd like to make is that in the marketplace today, and I am an active broker in the real estate business, there is an equity paralysis in investment real estate. As a result of the 1986 Tax Reform Act, the sellers today currently are just simply not selling properties. So when you look at any revenue program and all the realizations and all the things you're doing, the real reality of the marketplace is people simply aren't selling their income-producing properties. I'll give you one small simple reason why, one little case:

Take a $50,000 piece of income real estate a person bought in 1981, and let's presume he put 20 percent down or $10,000 down in buying that. They have a $40,000 mortgage. Eight years later they look at an offer to purchase of $55,000, an increase of $5,000, and they have paid the mortgage down to $35,000, so they have $20,000 worth of equity. What happens when they go to sell that, when they go to their accountant and say, what happens to me when I sell this?

Over that 8-year period because of the accelerated cost recovery system, there is about $25,000 of recapturable taxable income. In Wisconsin, we have a 7-percent State tax. When we combine that with your Federal and State tax, 40 percent of that gain now is going to be taxed.

So of the $25,000 gain, there is going to be $10,000 that go to taxation. You add to that the closing costs of putting that transaction together, which is about another $5,000. Now, what happens if that person goes to sell it is, he had a $20,000 asset, but $15,000 goes to taxation and closing costs, so literally three-quarters of his equity is gone. On his net worth statement he had $20,000, and now it's down to $5,000 if he sells it. He simply doesn't sell it.

We've had clients that put property on the market, and after accepting an offer to purchase, go to their tax counsel and try to get out of the transaction because they found it cost them too much. What's happened is the sellers have no motivation to sell, and that capital is frozen in the marketplace. So what taxation you think you're going to get through people selling, you simply aren't going to get.

The next point I'd like to make is in regard to the inflation adjustment. The administration proposal suggests that we have to have capital gains on stocks and bonds because we have to adjust for inflation. Yet long term to the stock and bond market is a year. The average holding period for real estate is 5 to 7 years.

Under the chart No. 8 of our written materials, we showed that investment real estate and nonhome real estate inflates just as much as the stock and bond market, and in fact, that ought to be included.

The last point I'd like to make is in regard to tax shelters. Many people are opposed to capital gains in real estate because it might be a return to tax shelters. I can suggest to you that in 1981 that when we received the accelerated cost recovery tax candy that was poured upon our industry, which many of us never really asked for, with opportunities far greater for write-offs than we ever expected to have, since that time there have been 17 proposals that have eroded the tax benefits for income real estate, including the devastating 1986 Tax Act. And the 17 proposals, it's like cutting off a dog's tail an inch at a time because you don't want to hurt it.

You have over these past years methodically chipped away from the tax benefit slate. We contend to you with all of the tax restrictions that are now applicable to income real estate, you have no longer a tax shelter there. Most buyers who used to think it was a reasonable thing to do are no longer in that marketplace.

I suggest to you that this would be a signal, and a reasonable signal, saying that the penalties and tax penalties over the last 7 years now are at an end, and you may again get back into this investment opportunity and see capital pooling so that we might meet the real estate needs of America.

In conclusion, we'd welcome capital gains if you'd put the real estate component in. We think that if you do it, that you'll make the proposal far more progressive and far more equitable, that the 5- to 7-year holding period of the average real estate person ought to be rewarded and not penalized, and that you'll improve the affordability of housing, and you'll end some of the equity paralysis that's in the market.

We thank you for the opportunity of testifying. We'll respond to questions later.

[The statement of Mr. Flynn follows:]

STATEMENT OF THE
NATIONAL ASSOCIATION OF REALTORS®
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
APRIL 13, 1989

INTRODUCTION.

Mr. Chairman and Members of the Committee. My name is Norman Flynn. I am a REALTOR® from Madison, Wisconsin, and am also the 1989 President-Elect of the NATIONAL ASSOCIATION OF REALTORS®. The Association represents virtually every facet of the real estate industry, including REALTORS®, developers, appraisers, syndicators, and property managers. On behalf of the more than 800,000 Members of our Association, I want to thank you for holding these hearings and for receiving our testimony on the Administration's proposal to restore a capital gains exclusion.

The NATIONAL ASSOCIATION OF REALTORS® would have wholeheartedly embraced the Administration's proposal had it reinstated prior law. Instead, the proposal is a curious concoction that creates new complexities and distorted incentives under the guise of encouraging long-term investment. It is a proposal that claims to encourage investment in productive assets, while it tilts taxpayers toward investments in securities, including bonds that are properly characterized as debt, rather than equity. It purports to mitigate the effects of inflation, but only for some assets. It claims to stimulate entrepreneurial activity, but only in limited sectors. Thus, as much as the NATIONAL ASSOCIATION OF REALTORS® would encourage a restoration of capital gains tax incentives, the Association can endorse that principle only if the Administration's proposal is modified and extended to include depreciable property.

At this time, the REALTORS® are neither advocating nor opposing a tax bill in 1989, nor are we insisting that a capital gains cut that includes depreciable property be enacted this year. We believe the elimination of capital gains treatment in 1986 was undertaken without sufficient analysis. Thus, we hope that restoration of the capital gains rules of prior law will be carefully thought out and laid on a solid, stable foundation.

WHO OWNS WHAT? INCOME AND ASSET DISTRIBUTION.

A proposal to reduce capital gains taxes almost always inspires the reflexive opposition of those who believe that the benefits of these rules inure solely to "the rich." The criticisms mounted in this vein in 1989 are nearly identical to the charges made against the Steiger-Hansen amendment in 1978, alleging that reduced capital gains taxes were a "windfall to the rich." Without conceding the validity of this criticism, the NATIONAL ASSOCIATION OF REALTORS® does believe that the President's proposal is indeed regressive when compared with the distributional effect of adding depreciable real estate to the proposal.

A condensed compilation of Federal Reserve data, based on the 1986 Survey of Consumer Finances, reveals some interesting facts about the ownership of real estate and the ownership of financial assets. Appendix Table 1 (Ownership of Real Estate) shows the incidence of ownership of homes and nonhome (or nonowner-occupied) real estate assets by size of household.

Undeniably, there is a concentration of ownership of real property assets in the higher income groups. The concentration of ownership of stocks and bonds, however, is even more steeply tilted to the wealthy. Appendix Table 2 (Ownership of Stocks and Bonds) shows this effect.

These two tables show that the greatest concentration of real estate ownership, by household, is in the income groups below $150,000, but the greatest concentration of wealth in the form of stocks and bonds is in the sector that represents only one percent of the households in this country. More specifically, we see the following characteristics:

- The wealthiest 1 percent of the household population (those with over $150,000 in income) makes 12 percent of total income, and holds a disproportionate amount of total wealth in the form of financial assets. This group holds 45 percent of the bonds and 43 percent of the stocks (measured in dollars), while earning 12 percent of total income. Thus, the uppermost income class holds a disproportionate share of capital gains-producing assets eligible for tax relief under the Administration's proposal.

- Households with incomes between $30,000 and $150,000 make up 33 percent of that population, receive 57 percent of the total income, and hold 38 percent of the bonds, and 43 percent of the stocks. Thus, these households own a smaller proportion of stocks, relative to income, than the highest income group.

- Households making incomes less than $30,000 account for 66 percent of the total households, but receive only 31 percent of total income. They hold a disproportionately small amount of the financial assets that would benefit from the Administration's capital gains proposal. This group holds only 17 percent of total bonds and 14 percent of stocks. Thus, lower income households would receive only negligible benefit from the Administration's proposal. The financial assets in these households consist mostly of saving accounts, CDs and IRAs. The President's proposal does include special provisions excusing the lowest income households from paying any capital gains tax, but these breaks are not terribly meaningful if these taxpayers hold only minimal amounts of stocks or other qualified assets.

By contrast, households in all three income groups hold nonowner-occupied real estate roughly in proportion to their income. Table 1 indicates that:

- Households with income less than $30,000 earn 31 percent of total income and hold 32 percent of nonhome real estate.

- Households in the $30,000 to $150,000 income class receive 57 percent of the income and hold 52 percent of nonhome real estate.

- The wealthiest group of households, those making over $150,000, receive 12 percent of the income and hold 16 percent of the total nonhome real estate.

We can conclude, then, that a reduction in the capital gains tax for nonhome or nonowner-occupied real estate would benefit all households in proportion to their income.

Note that under current law, owner-occupied residences are generally protected from capital gains taxation and would therefore be relatively unaffected by the Administration's proposed changes. Secretary Brady and Acting Assistant Secretary for Tax Policy Dennis Ross have testified before this Committee that the rules for rollovers and the one-time $125,000 exclusion for taxpayers age 55 and over on sales of principal residences would be unchanged under the Administration's proposal. They have also confirmed that gains from partial rollovers would be eligible for the proposed 45 percent exclusion, as would gains in excess of $125,000 realized by taxpayers 55 years of age and older.

No matter what one chooses to believe about the rhetoric of tax benefits for the wealthy, it is clear that the Administration's proposal as currently configured is regressive and overwhelmingly favors holders of securities. Extending the proposal to include real estate cannot cure the regressivity, but including real estate can mitigate some regressivity. As Appendix Table 3 (Combined Holdings of Stocks, Bonds and Real Estate) indicates, households own the combination of stocks, bonds and real estate (including homes) in about the same proportion as their income. Thus, extending the President's proposal to include real property benefits all households in a roughly equitable manner.

REVENUE IMPACT OF THE PROPOSAL: THE INCENTIVE EFFECT.

The NATIONAL ASSOCIATION OF REALTORS® recognizes that much of the debate about the merits of the capital gains proposal will focus on its effect on Federal revenues. The NATIONAL ASSOCIATION OF REALTORS® takes no position on the correctness of the revenue results forecast either by the Administration or the Joint Committee on Taxation, and has no particular methodology to advocate for assessing or projecting revenue effects. We do, however, wish to emphasize some features common to both sets of revenue estimates and to make some observations about and occasionally to challenge the assumptions, both implicit and explicit, inherent in the behavioral responses forecast in the Administration's proposal.

No Revenue Loss from Depreciable Property. First, under either the Treasury's or the Joint Committee on Taxation's revenue estimates, the inclusion of depreciable property does not cause revenue losses during a five year period. In preparing Appendix Tables 4 and 5, we have netted the amounts shown in the Treasury and Joint Committee on Taxation tables in lines marked "Total Revenue Effect" and "Exclusion of Certain Asset Types." The revenue effect shown in the line marked "Exclusion of Certain Asset Types" in the Joint Committee on Taxation analysis is presumed to include collectibles and depreciable property other than real estate, as it does in the Treasury data. For convenience, we have made no assumptions about the proportion of those figures that represents collectibles and other depreciable personal property. Rather, we have merely used the totals provided as representative of the effect of including improved real estate in a capital gains reduction proposal.

Appendix Table 4 (Revenue Effects of Including Depreciable Property--Treasury) shows Treasury's own data, indicating that including depreciable property in the class of qualified assets eligible for capital gains treatment would still generate additional revenues, although by a lesser amount. Even if the larger amount of the Joint Committee on Taxation's estimates on the revenue effects of depreciable property were applied against Treasury revenue projections, there would still be a modest net revenue increase through 1992. (See Appendix Table 5, Revenue Effects of Including Depreciable Property--Joint Committee on Taxation.) It should be noted that applying this same netting technique to the Joint Committee's revenue projections shows that the inclusion of depreciable property in a capital gains tax reduction proposal would result in revenue losses as early as 1991.

Tax-Based Incentives--Investor Behavior. We acknowledge that this simple netting of one line against another is a facile analysis, and that many dynamic factors are operative any time economists attempt to quantify and assess incentive effects. We will leave to the econometricians the assessment of the most correct method of quantifying incentives. We know a host of variables that are completely outside the tax system affect investment choices and that these factors may vary substantially even among similarly-situated taxpayers. These might include broad, measurable factors such as interest rates, inflationary pressures, recession, or more practical, but nonquantifiable considerations like risk, paying tuition or needing liquidity. Thus, while this statement may be glib, we also believe that it is intuitively obvious that, all other things being equal, the lower the tax cost, the more attractive the investment.

The debate about revenue and incentive effects could fairly be characterized as a conceptual debate about likely outcomes of two fundamental investor behaviors: the choice of investment vehicles and the timing and frequency of realizations. If choices about investment vehicles were made solely on the basis of tax cost, then clearly the Administration's proposal, by providing a substantially lower tax cost for dispositions of nondepreciable property, creates a strong bias toward investment in intangible or nondepreciable property. Clearly, the kinds of intangibles that would benefit most from the Administration's proposal are securities. This includes not only stocks, or equities, but also bonds, including junk bonds, that represent debt. Given the concerns expressed in this Committee and elsewhere about the proliferation of debt, we question the validity of providing further tax incentives for these instruments.

Thus, we challenge the assumption inherent in the Administration's proposal that suggests, for example, that it is somehow less "productive" for a taxpayer to invest in an apartment building than for the taxpayer to invest the same amount of money in shares of a mutual fund that invests heavily in the junk bond market. Nonetheless, the Administration's proposal would clearly favor investment in the intangible asset, as the tax cost of ownership would be more favorable for the mutual fund shares.

The other behavioral response to be scrutinized in the debate on revenue and incentive effects is the volume and timing of realizations. Joint Committee on Taxation Chief of Staff Ronald A. Pearlman revealed at a recent Senate Finance Committee hearing that capital gains realizations would have to double *permanently* to preclude sustained revenue loss under the President's proposal. Pearlman further argued that such performance defies historical evidence. Nonetheless, in support of its proposal, the Treasury projected a $9.3 billion increase in revenue for fiscal years 1989 through 1994. However, the Joint Committee on Taxation, projecting a slower pace of realizations, has estimated that the proposal would lose over $23.9 billion over the same period.

Realizations and Lock-In. The discrepancy in revenue estimates exists in part because of controversy over the effect of tax rate changes on capital gains realization rates. A tax cut would be expected to reduce revenue if the rate of realizations remains the same. However, a reduction in tax rates is expected to increase the frequency of realizations. If realizations increase significantly enough, tax revenue could actually increase due to a tax cut. Studies using different data and methodologies have arrived at opposing conclusions on the effect on revenues of a tax reduction for capital gains. A 1985 Office of Tax Analysis study[1] found that although real estate capital gains realizations are not responsive enough to rate changes to offset the revenue reduction from a tax cut, the capital gains tax reductions in the 1978 and 1981 Acts both raised revenue. However, a 1981 study[2] prepared for the Treasury by Gerald Auten, Professor, Bowling Green State University, found that a capital gains tax rate reduction for real estate would be approximately self-financing.

Historically, investors in real estate have tended to hold their assets for long periods of time without churning. The transaction costs associated with real property transactions are generally higher than for financial assets. Also, the process of transferring real estate is substantially more time consuming than buying or selling securities. In this regard, then, real estate investors are in conformity with the Administration's goal of lengthening the time horizon for investor decisions. Unfortunately, the Administration's proposal could have the undesirable effect of changing this long-term-growth perspective of the real estate investor into a complete lock-in of gains on real property assets. A lock-in of gains would be completely contrary to the Administration's apparent goals if, as the Joint Committee has illustrated, unlocked gains and increased realizations generate a substantial portion of the revenue gains the Administration projects.

Existing Capital--FSLIC. We do have some concern about the effect of a new incentive on existing capital markets and pools of capital. One effect of changes in tax incentives for different types of investments can be a simple reallocation of already existing capital from one investment vehicle to another. Take for example, the provision for tax-exempt saving certificates enacted in 1981 and available throughout 1982. A disappointing result of that experiment was that very little new saving occurred. External factors including a flat housing market, high interest rates and recession in 1982 no doubt impeded capital flows, but the bald fact remains that there was little new saving. Rather, assets were simply moved around so that some otherwise taxable income could be converted to nontaxable income. In today's capital markets, given the vulnerability of the thrift sector, it seems advisable to move cautiously in enacting proposals that could unintentionally shift even more capital out of this sector.

Another point on incentives is noteworthy in the context of the FSLIC crisis. By excluding improved real estate, both residential and nonresidential, from capital gains treatment on sale, the Administration's proposal could exacerbate the current FSLIC crisis. It could become more difficult for FSLIC to sell improved real estate acquired by default or on foreclosure if capital gains treatment were unavailable to a subsequent purchaser. Clearly, investors would be more attracted to assets on which the after-tax return is higher as a consequence of the capital gains exclusion. Investors would shun assets, such as improved real estate, that suffer from adverse tax treatment under the Bush proposal. This scenario would only compound the problems for FSLIC by making it more difficult to dispose of their real estate inventory. Nonetheless, great care must be exercised so that FSLIC properties are not unduly advantaged relative to other real property.

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[1] Office of the Secretary of the Treasury, Office of Tax Analysis, Report to Congress on the Capital Gains Tax Reductions of 1978 (September 1985).

[2] Gerald E. Auten, "Estimation of the Effects of Capital Gains Taxes on the Realizations of Capital Gains, "Final Report on a Project for the Office of Tax Analysis, U.S. Department of the Treasury (October 21, 1981).

HOUSING AFFORDABILITY.

Another incentive aspect of the proposal is its provision of tax benefits for assets that yield large capital gains (and generally carry more risk) as opposed to those with consistent yields, less risk, and lower capital gains. Taxpayers making decisions about new investments would no doubt welcome a restoration of capital gains benefits as a tool to clarify their risk analysis of new ventures. We do not doubt that there is a correlation between the incentive effect of capital gains treatment in attracting capital to new ventures, particularly in emerging technologies with great potential for new jobs and for improvements to both industrial productivity and the quality of life. We believe, however, that entrepreneurial incentives are also appropriate in real estate markets.

The rate of homeownership among young adults has declined substantially in the last decade. After increasing for many years, homeownership for households of persons between ages 25 to 34 declined from 52.3 percent in 1980 to 45 percent in 1988. Similarly, for the population at large, the portion of all households owning their own home declined from 65.6 percent to 63.8 percent. The NATIONAL ASSOCIATION OF REALTORS® is on record supporting changes to our Nation's housing policies that could ameliorate some of the difficulties that face homebuyers. (See Appendix Table 6, Affordable Housing, for a summary of issues that could be addressed in this Congress.)

We will not represent to the Committee that restoring pre-1987 law as it relates to capital gains for real estate will cure the Nation's affordable housing problems. We note, however, that current law recognizes the importance of capital gains treatment for homeowners. Relevant provisions are the exclusion of gain on rollovers and the $125,000 exclusion for taxpayers age 55 and over. On the rental side, therefore, we urge the Committee to note that failure to extend capital gains treatment to the owners of rental real estate will not relieve any of the upward pressure on rents. High rent burdens make it more difficult for renters to save for a downpayment, thus setting off a spiraling cycle that harms individuals and communities alike. Again, however, we urge the Committee to exercise great care in shaping tax policies that extend into our home and community lives.

Appendix Table 7 (Price and Cost Indexes--Consumers and Construction) presents data comparing the Consumer Price Index (CPI), the price index for the sale of single-family homes, and a standard index for the costs of building for a constant quality unit. For every year presented except 1979, 1980, and 1981, the costs for residential-type property exceeded those for commercial and industrial property. During those three years, the costs for small, residential structures exceeded costs for commercial and industrial properties. Throughout the decade of the 1980s, the Consumer Price Index, used to measure general inflation, has risen more slowly than the index of costs associated with building. Thus, we believe that it is unwise to impose additional tax costs, as compared with other assets, on real property.

TAXING INFLATIONARY GAINS.

One reason the Bush proposal cites for restoring capital gains for certain assets is provision of ". . . a rough adjustment for the inflationary element of capital gains." If the Bush proposal is not amended to restore capital gains treatment to the sale of improved real estate, inflationary gain attributable to improved real estate will be taxed at the higher ordinary income rates, while other assets will have some or all of the tax on inflationary gain eliminated by reason of the capital gains exclusion. Does this mean that inflationary gain attributable to the sale of improved real estate is less objectionable than inflationary gain attributable to the sale of stock and securities? Moreover, because real estate tends to be held for a much longer period of time prior to sale (five to seven years on the average), the perverse logic used to justify capital gains for some assets and not for others would tend to imply that inflation is less onerous where the assets are held for a longer period of time.

In fact, of all the assets previously eligible for the capital gains exclusion of pre-1987 tax law, improved real estate is arguably the category of assets most deserving of a capital gains exclusion. The historical long holding period (five to seven years) for real estate exacerbates the need to ameliorate the effects of inflation. Furthermore, by granting the capital gains exclusion to gain from the sale of raw land, but not to gain from the sale of structural improvements, the proposal suggests that inflation only affects unimproved land and not buildings. We reject that conclusion. Thus, depreciable property, or improved real estate should receive the same relief for the effects of inflation as other assets.

Appendix Table 8 (Price and Cost Indexes--Consumers and Construction) shows an index of inflation during the 1970s, a period of high inflation, and the 1980s, a period of relatively low inflation. Building on the data shown in Table 7, Table 8 shows the total change in the prices and costs of commercial and residential property for five-year increments during that period. Based on these data, we believe it is patently absurd to suggest that real estate is somehow less subject to the vicissitudes of inflation than other assets. We, therefore, believe it appropriate to include improved real estate in the category of assets that qualify for the "rough adjustment for the inflationary element of capital gains."

TAX SHELTERS.

If the tax reforms of the 1970s seemed, on the whole, to have minimal effect on various techniques used to generate capital for real estate development, the opposite can be stated for the tax reforms of the 1980s. Every broad-based tax bill since the watershed Economic Recovery Tax Act of 1981 has contained provisions that have increased the tax costs of real estate development and made it more difficult to raise capital for these activities. Many of these were enacted with the sometimes-warranted, but sometimes overly-broad, objective of cutting back on tax shelters. These provisions include:

- Longer depreciable lives for real property
- Passive activity loss limitations
- Net investment interest limitations
- Capitalization of interest expense
- Original issue discount measurements
- Interest-free loan limitations
- Limitations on deferred rents
- Alternative minimum tax (individual and corporate)
- Elimination of capital gains exclusions
- Reduced credit for historic rehabilitation
- Partnership restrictions
- Increased information reporting
- Installment method accounting limitations
- Completed contract method accounting limitations
- Cash method accounting limitations
- Taxable year limitations
- At-risk rules for real estate

With all of these restrictions in place, we would respectfully suggest to the Committee that there is not much shelter left.

Notwithstanding all of these limitations, we are aware of the Committee's concern that the restoration of prior law could restore the opportunity for taxpayers to reduce ordinary income with real estate tax losses, including depreciation, and then dispose of the assets with any gain taxed at lower capital gains rates. In the past, the Section 1245 and 1250 depreciation recapture rules protected some portion of the Treasury revenue from erosion. We would be pleased to work with the Committee to craft a revised recapture rule in the context of a capital gains reduction.

CONCLUSION.

The NATIONAL ASSOCIATION OF REALTORS® appreciates this opportunity to testify. We reiterate the message that we would welcome a restoration of capital gains incentives, so long as they extend to depreciable real estate. We believe that extending capital gains to improved real estate eliminates some of the regressive aspects of the President's proposal. Capital gains preferences are appropriately extended to real estate to mitigate the effects of inflation. These tax benefits are consistent with our Association's and our Nation's goals of affordable housing. We, therefore, urge the Committee to extend favorable treatment to real estate when the issue of capital gains is before the Committee. We pledge to work with the Committee to craft rules that will respond to the Committee's desire to prevent abuse of the tax system.

TABLE 1

OWNERSHIP OF REAL ESTATE BY INCOME CLASS

(1985 TOTALS - EXPRESSED AS PERCENTAGES)

Income Class Total Income From - To	Number of Households	Total Income	Market Value of Home	Market Value of Non-Home Real Estate
$0 - $30,000	65.98%	31.21%	39.67%	31.94%
$30,000 - $150,000	33.05	56.69	54.35	52.06
Over $150,000	0.97	12.10	5.98	16.00
Total	100%	100%	100%	100%

Source: 1986 Survey of Consumer Finances, Federal Reserve. Condensed Version of Tabulations by Price-Waterhouse.

TABLE 2

OWNERSHIP OF STOCKS AND BONDS

Income Class Total Income From - To	Bonds (by value) ($ millions)	Bonds (Percentages)	Stocks (by value) ($ millions)	Stocks (Percentages)
$0 - $30,000	$ 73,780	17.18	$174,787	14.03
$30,000 - $150,000	162,768	37.89	531,680	42.68
Over $150,000	192,978	44.93	539,178	43.29

Source: 1986 Survey of Consumer Finances, Federal Reserve. Condensed Version of Tabulations by Price-Waterhouse.

TABLE 3

COMBINED HOLDINGS OF STOCKS, BONDS AND REAL ESTATE

(MEASURED BY INCOME CLASS-HOUSEHOLD ASSETS)

Income Class From - To	Total Households (Percentages)	Total Income (Percentages)	Combined Assets ($ millions)	Combined Assets (Percentages)
$0 - $30,000	65.98%	31.21	$3,504,804	32.29
$30,000 - $150,000	33.04%	56.69	5,692,350	52.94
Over $150,000	0.97%	12.10	1,657,702	15.27

Source: 1986 Survey of Consumer Finances, Federal Reserve. Condensed Version of Tabulations by Price-Waterhouse.

TABLE 4

REVENUE EFFECTS OF INCLUDING DEPRECIABLE PROPERTY--TREASURY (BILLIONS OF DOLLARS)

Year	1989	1990	1991	1992	1993	TOTAL
Total Revenue Increase	0.7	4.8	4.9	3.5	2.2	16.1
Effect of Depreciable Property	0.2	1.2	1.7	1.9	2.1	7.1
Net Revenue Increase	0.5	3.6	3.2	1.6	0.1	9.0

Source: Department of the Treasury Office of Tax Analysis, 1989.

TABLE 5

REVENUE EFFECTS OF INCLUDING DEPRECIABLE PROPERTY--JOINT COMMITTEE ON TAXATION (BILLIONS OF DOLLARS)

Year	1989	1990	1991	1992	1993	TOTAL
Total Revenue Increase (Treasury)	0.7	4.8	4.9	3.5	2.2	16.1
Effect of Depreciable Property (Joint Committee on Taxation)	0.2	1.3	2.7	2.9	3.1	10.2
Net Revenue Increase	0.5	3.5	2.2	0.6	(0.9)	5.9

Source: Joint Committee on Taxation Testimony before Senate Finance Committee, March 14, 1989. JCX-3-89

TABLE 6

AFFORDABLE HOUSING

WHAT IS THE ISSUE?

- The rate of homeownership among young adults has declined substantially in the last decade. After increasing for many years, homeownership rates for households between 25 and 34 years of age declined from 52.3% in 1980 to 46% in 1988.

- Prior to 1980, the homeownership rate had been increasing steadily. Then it began decreasing; between 1980 and 1988, the percent of all households owning their own home declined from 65.6% to 63.8%.

- First-time homebuyers are having greater difficulty purchasing homes because of escalating housing prices, higher downpayment requirements, higher rent burdens that make saving for a home more difficult, and higher interest rates that increase monthly payments.

- Meantime, the FY 1990 Budget request would worsen affordability with new or increased fees on housing credit that would be a tax on housing. Also, proposed "credit reform" legislation would create pressure to reduce program activity or raise fees.

WHAT ACTION IS NEEDED?

Increase Access to Federal Housing Administration (FHA) Mortgage Insurance

- There are three main reasons why many potential homebuyers cannot utilize the mortgage insurance programs of the Federal Housing Administration (FHA): housing costs that exceed the FHA maximum mortgage limits, high downpayment requirements, and monthly payments that exceed a potential buyer's ability to pay.

- To address these problems, the NATIONAL ASSOCIATION OF REALTORS® supports: raising the FHA maximum mortgage limit to 95% of area median sales price, lowering downpayment requirements under the FHA program to 3% of the first $50,000 and 5% of the amount of the mortgage exceeding $50,000, and authorizing FHA to insure adjustable rate mortgages (ARMs) more reflective of standard ARM products in the mortgage market (specifically, an ARM that can adjust 2% annually and 5% over the life of the loan). These issues are addressed in a number of bills, such as S. 565 (Cranston/D'Amato) and H.R. 812 (Price/Wylie).

- Raising the FHA maximum mortgage limit to 95% of an area's median sales price recognizes that housing prices vary greatly between cities and regions and would allow moderate-income homebuyers to use this program in areas where they currently cannot.

- Lowering downpayment requirements under the FHA program will benefit many individuals and families who are trying to save for a downpayment but cannot keep up with rising home prices.

- Authorizing FHA to insure ARMs that adjust 2% annually and 5% over the life of the loan would make available to more homebuyers a mortgage product that has been successfully utilized by the conventional mortgage market for many years, thus providing a useful loan product whose monthly payments are much more affordable than those for a fixed rate loan.

TABLE 6 (Continued)

Preserve the Existing Low-income Housing Stock

- Over the next decade, hundreds of thousands of low-income rental housing units may become less affordable to low-income persons when owners of these complexes elect to prepay their mortgages and terminate the current low-income use restrictions or when HUD rental assistance subsidy contracts expire.

- The NATIONAL ASSOCIATION OF REALTORS® urges Congress to provide effective financial incentives to encourage owners of HUD-assisted low-income rental housing units to continue to provide affordable housing.

Provide Monthly Payment Assistance to First-time Homebuyers

- Because many potential homebuyers are unable to purchase homes because they are unable to meet the necessary monthly mortgage payments, the NATIONAL ASSOCIATION OF REALTORS® supports the concept of creating an interest rate subsidy program to reduce the monthly mortgage payments of first-time homebuyers. H.R. 1180 (Gonzalez) would authorize an interest rate subsidy program.

Avoid Fees and Restrictions on Housing Credit

- The NATIONAL ASSOCIATION OF REALTORS® opposes new or increased fees which would increase the cost of housing credit programs (Fannie Mae, Freddie Mac, Ginnie Mae, FHA, VA) that help potential homebuyers gain access to home purchase financing.

- Therefore, Congress should defeat the fee increases specifically included in the FY 1990 Budget and the so-called "credit reform" legislation which would create pressure to reduce program activity or raise fees for all government credit programs.

TABLE 7

PRICE AND COST INDEXES CONSUMERS AND CONSTRUCTION
(CPI:1982-84=100, Construction indexes:1982=100)

			E.H. Boeckh, building cost index:		
Year	Consumer Price Index (All items)	Price Index for new one-family sold	Small Residential Structures	Apartments, Hotels, Office Buildings	Commercial & Factory Buildings
1970	38.8	35.1	38.3	38.3	36.6
1971	40.5				
1972	41.8				
1973	44.4				
1974	49.3	45.7	53.8	51.9	50.9
1975	53.8	52.3	57.4	57.1	56.2
1976	56.9	55.4	62.2	61.6	61.0
1977	60.6	61.9	67.8	66.7	65.8
1978	65.2	70.4	73.9	71.8	70.8
1979	72.6	80.1	80.7	76.5	77.1
1980	82.4	88.8	87.4	83.4	84.1
1981	90.9	97.0	92.2	91.6	92.2
1982	96.5	100.0	100.0	100.0	100.0
1983	99.6	102.6	105.9	106.4	105.3
1984	103.9	106.2	111.9	111.2	109.4
1985	107.6	108.4	115.1	113.0	111.3
1986	109.6				
1987	113.6				
1988					

Source: Statistical Abstract of the United States, Economic Report of the President. From U.S. Department of Commerce, Bureau of the Census, U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 8

PRICE AND COST INDEXES CONSUMERS AND CONSTRUCTION FIVE YEAR PERCENT CHANGES

			E.H. Boeckh, building cost index:		
Year	Consumer Price Index (All items)	Price Index for new one-family sold	Small Residential Structures	Apartments, Hotels, Office Buildings	Commercial & Factory Buildings
1970-75	38.66%	49.00%	49.87%	49.09%	53.55%
1975-80	53.16	69.79	52.26	46.06	49.64
1980-85	30.58	22.07	31.69	35.49	32.34

Source: Statistical Abstract of the United States, Economic Report of the President. From U.S. Department of Commerce, Bureau of the Census, U.S. Department of Labor, Bureau of Labor Statistics.

Mr. **Gephardt** [presiding]. Thank you very much. Ms. Sigal.

STATEMENT OF ELLEN V. SIGAL, MEMBER OF THE BOARD AND CHIEF EXECUTIVE OFFICER, SIGAL/ZUCKMAN COS.

Ms. **Sigal.** Good morning, Mr. Chairman, members of the committee. I'm Ellen Sigal of the Sigal/Zuckman Cos., and a principal in the Sigal Construction Cos. Our major thrust is commercial real estate, but we also engage in multifamily housing in the Washington metropolitan area.

I'm here today representing the National Realty Committee. We are submitting joint testimony with the Building Owners and Managers Association International, International Council of Shopping Centers, and the National Association of Industrial and Office Parks. You'll be hearing from the other members shortly.

While I am on National Realty Committee's board, I am not the largest and best-known developer in National Realty Committee. I'm not even the largest developer in Washington, DC. However, I am here today because I am more typical of the developers across America, the developers in your district and your hometowns, men and women who have struggled to establish local firms to build new office buildings, modernize old shopping areas, and create new industrial parks, and provide families with homes and apartments.

We're here to discuss the proposed capital gains tax cut, from which the "kinder and gentler" administration would exclude depreciable real estate, the one major capital gains investment more Americans own than any other.

For once the committee faces a very simple choice, if there is to be a capital gains tax cut, shall real estate be excluded from it as the administration proposes or included in it as we unanimously advocate.

To exclude real estate, which is literally the physical foundation for the rebuilding of America to compete in the modern world, you would have to believe three things: First, that real estate development should not be encouraged to enhance American economic growth; second, that real estate development should not be encouraged to rebuild the aging cities and towns of America; and third, that excluding real estate from capital gains treatment would be fair to all Americans. Apparently, the administration believes that. We think they are wrong, very wrong.

The administration's position ignores millions of jobs, vital facilities in every town, and the modernization for competitiveness which real estate development provides. Real Estate generates more than two-thirds of all taxes raised by State and local governments. Where do those taxes go? They go to schools, they go to hospitals, they go to roads, and other vital services.

The administration wants long-term investment. What long-term investment could be more vital than investment in construction, in affordable multifamily housing, modern factories, in new warehouses for improved distribution, and in new offices built for modern communications and information processing.

Excluding real estate from capital gains treatment would stifle the long-term growth we all want. Let me be very clear, our industry did not go to Congress this year seeking a capital gains tax reduction. First, we recognize the enormous budget pressures on this committee. Second, we thought it more urgent for us to seek to correct some of the passive loss rules which have crippled the multifamily housing industry, contributed to the housing shortage, and will, in the long run, drive up the cost of housing—insuring that affordable housing will never be accomplished in the United States.

But while we didn't seek a capital gains tax cut, we don't want to be the victim of one. For if we are the victim, so is every person who owns depreciable real estate, so is every town seeking to rebuild its aging neighborhoods and bring in new business; so is every new family seeking an affordable place to live, and so is every industry seeking to modernize factory buildings and distribution centers.

To those who say you overstate, real estate development can't rebuild America—I ask you to look out your window and look down Pennsylvania Avenue. There, more than $1 billion in private investment turned an urban blight into a showcase, providing housing as well. Why should we discourage that? Why should we want to provide a disincentive for that?

This exclusion would hurt us, but even more it will hurt contractors, construction workers, manufacturers, skilled and day laborers for whom we provide the biggest, best-paying jobs, from stone quarries in New England to lumber camps in the Pacific Northwest, from carpet mills in the Carolinas, to plumbing companies in the Midwest. This proposed exclusion will mean real loss and real pain.

We do not seek to reinstate, as we do not seek to preserve the excessive benefits of tax shelters, but we think that excluding real estate from a capital gains tax reduction sends a very wrong message to America. It sends a message of don't invest in rental homes for Americans or in your hometown. Don't put your dollars into building something real, something needed, something substantial and valuable. Instead, send your dollars to Wall Street where they may be part of a corporate takeover that only creates debt—but you'll get better tax treatment for being part of that.

The administration is seeking to build a wall around the American economy with all businesses inside the walls and only real estate outside. Robert Frost once said "Before I build a wall I'd ask to know what I was walling in or walling out, and to whom I was likely to give offense." This administration would have you wall out trillions of dollars worth of real estate which generate about $200 billion a year in taxes on income, property and sales. I believe that will give offense to all Americans committed to a level playing field from which we can energize all elements of our economy.

Mr. GEPHARDT. Thank you very much.

Mr. Shehadi.

STATEMENT OF MICHAEL T. SHEHADI, VICE CHAIRMAN, NATIONAL ADVISORY COUNCIL, BUILDING OWNERS AND MANAGERS ASSOCIATION, INTERNATIONAL, AND GROUP SENIOR VICE PRESIDENT, CHARLES E. SMITH COS.

Mr. SHEHADI. Mr. Chairman, members of the committee. I am Michael Shehadi, and I'm group senior vice president of the Charles E. Smith Cos. here in Washington. I am also a member of the Building Owners and Managers Association, International. I am vice chairman of Building Owners and Managers Association, International's National Advisory Council.

I'd like to thank you and the members of the committee for including us in this opportunity to testify on the capital gains tax proposal contained in the administration's fiscal 1990 budget.

Building Owners and Managers Association, International is the oldest and largest trade association representing the commercial office building industry, with 100 federated associations in the United States, Canada, and around the world. Building Owners and Managers Association, International has 7,200 members who are office building developers, owners, and managers who collectively own or manage 5 billion square feet of office space in North America.

I would like to direct my portion of our joint testimony on three reasons cited by the administration's proposal for lowering the capital gains rate for nondepreciable assets which also apply to depreciable real property. They are inflationary gains, the locking in of investments, and the concept of bunching.

First, inflationary gains. The administration in its budget proposal notes that even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a fictional element of profit represented by inflation. Investments in depreciable real property like investments in other assets such as corporate bonds and stocks are affected by the impact of inflation.

The inclusion of land in their proposal addresses some of the impact of inflation on real property, however, a gain on depreciable real property which generally represents the predominant part of the value of all real estate also was influenced by inflation.

To disregard the inflationary impact on depreciable real property, while recognizing it for other assets, is arbitrary, illogical, and poor tax policy. The 1986 Tax Act with its passive loss rules hammered our industry. Now this proposal explicitly discriminates against depreciable real estate.

The second point, the lock-in of investments. Another reason supporting a reduced tax rate for capital gains is to avoid locking in investments. The administration cites this rationale in the case of stocks and bonds, but not depreciable real estate. The administration correctly notes that without the penalty of paying ordinary rates on the gain from the sale of securities, investors will be more likely to trade more freely in these securities.

This rationale applies equally to depreciable real property. Indeed, the lock-in of real property may have a more adverse impact on the economy than the lock-in of stocks and bonds.

Free alienability of real estate insures that real property is employed in its highest and best use. This is vital to the functioning of an efficient economy. The investment in real estate in the United States is such a large percentage of total private, domestic investment that any decrease in the efficiency of its allocation can have a significant aggregate economic impact.

The administration argues that decisions to dispose of depreciable real property are based on business cycles and the condition of the particular asset and are not particularly sensitive to the capital gains tax rate. We have not seen evidence of this assertion.

The disposition of other depreciable property such as equipment may well respond in this fashion because of an inability to preserve the productive capacity of the equipment through substantial reinvestment or the limited value and gain on disposition. However, the disincentive to dispositions of real property because of a relatively high tax rates, all Federal, State, and local on the gain, and the consequent reduction in the funds available for reinvestment in another structure, is quite strong in some circumstances for owner/operators.

The disincentive may be even stronger for lessors who's decision on the disposition of their property are more independent of the particular situation of any individual business and more based upon aggregate, financial incentives and disincentives.

The third issue is bunching. Bunching occurs when gain, both real and inflationary that has accumulated over several years, is taxed in 1 year. This pushes the income of the taxpayer, including the income that otherwise would have been taxed at a lower tax rate, into a higher tax bracket in that year. The bunching problem typically is a more severe issue the longer the holding period because more years of accumulative gain are taxed in 1 year.

Investments in real estate typically are held for a longer period than investments in corporate stocks and bonds, therefore, bunching is a more serious problem for real estate than for the securities that are included in the administration's proposal.

In general, the bunching problem has been somewhat reduced by the adoption of a flatter tax rate system with 15 and 28 percent rates. However, bunching under the new system can affect lower income taxpayers more severely than under the old multi-tax system. The new 33 percent surtax may push all of the taxpayers income from the 15 percent bracket into the 28 percent bracket when a large amount of gain is subject to a tax in 1 year.

Again, thank you for the opportunity to present our comments on this issue.

Mr. Gephardt. Thank you very much.

Mr. Woodbury.

STATEMENT OF WALLACE WOODBURY, CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, INTERNATIONAL COUNCIL OF SHOPPING CENTERS AND CHAIRMAN OF THE BOARD, WOODBURY CORP.

Mr. WOODBURY. Thank you, Mr. Chairman. I am Wallace R. Woodbury, chairman of the board of the Woodbury Corp. of Salt Lake City, UT, a real estate development brokerage, management, and consulting firm. In addition, I am senior partner in the law firm of Woodbury, Bettilyon, Jensen, Kesler, & Swinton.

I appear here today as chairman of the Government Affairs Committee of the International Council of Shopping Centers, and I am testifying on behalf of the International Council of Shopping Center's 27,000 members.

You've just heard why the justifications cited by the administration in support of its capital gains proposal apply to depreciable real property at least as much as they apply to stocks and bonds, and, therefore, why lower capital gains rates should be applied to real estate. Now, I want to explain why two of the principal reasons asserted by the administration to justify not including relief for depreciable property, in its proposal are unfounded.

First, the administration proposes to effectively repeal section 1231 which provides net capital gain and net ordinary loss treatment both to depreciable real estate and land used in a trade or business. The administration asserts that capital gains treatment for such property is not warranted. In fact, section 1231 is a tax provision of longstanding which continues to be justified.

From 1942 to 1987 section 1231 property was accorded net capital gains treatment. In 1987, the reduced tax rate for capital gains was ended for all types of eligible property. During the 2-year consideration of the 1986 act, there was no debate on repealing the differential treatment of gain or loss under section 1231 as to some assets and not others, and no suggestion that gains on section 1231 real property improvements should be treated differently than gains on other capital assets.

Thus, for 47 years neither the Congress nor the Treasury sought to repeal the section 1231 rules even though the major revisions of the code in 1954 and 1986 took place. In addition, net capital gain and net ordinary loss treatment for section 1231 property continues to be justified on tax policy grounds.

Gains on the sale of depreciable real property should continue to receive the same treatment as gains on the sale of stocks and bonds and other capital assets. All are long-term assets which similarly, are important to competitiveness, and similarly affected by inflation, by the walk-in effect, and by bunching. In addition, identical treatment of gains would avoid distorting investment decisions.

Losses on depreciable real property used in a trade or business should continue to receive the same treatment as losses on other trade or business property. If the taxpayer has net section 1231 property losses, he virtually by definition has been involved in a trade or business failure, and should be able to deduct his business losses without limitation so that he can maximize the availability of his remaining capital for investment in another business.

Section 1231 treatment of both land and depreciable real property used in trade or business also avoids contentious allocation problems between land and buildings, an advantage over the administration's proposal.

Second, the administration has asserted that extending the lower tax rate to gains on depreciable property, it would make tax shelter investments more attractive. This is at odds with the facts. The Tax Reform Act of 1986 created multiple disincentives for investing in real estate tax shelters. Depreciable lives for rental property were nearly doubled. The application of the minimum tax was substantially strengthened. Numerous construction costs were required to be capitalized rather than expensed. The at-risk exceptions were narrowed. The deductibility of interest was limited. And limitations on the use of real estate losses we imposed through by the passive loss rules.

These changes and limitations would not be overcome in any way by a lower tax rate on capital gains for depreciable real estate. Indeed, the 1986 act went too far by penalizing the ownership and operation of rental buildings by real estate professionals through its treatment of these long-recognized businesses as tax sheltered investments, when they are really operating businesses.

We think it unlikely that providing the same tax rate reduction for investments in depreciable real property, as would be provided to other assets, would create an incentive for tax shelter investments in real estate in the face of the many restrictions already imposed on such investment by the 1986 act.

In summary, the principle reasons asserted by the Administration for excluding depreciable property from its capital gains proposal do not stand close scrutiny.

We urge the committee to reject the administration's analysis of these issues and to insure that any legislation which provides a lower tax rate for capital gains applies equally to depreciable real property as to other assets. Thank you very much, Mr. Chairman.

Mr. **Gephardt**. Thank you.

I'd now like to welcome Charles Tureen who is a resident from the city from which I come, St. Louis. That doesn't make him any more important than any of our other speakers, but I wanted to recognize him for his good work in the real estate area in our town, and welcome him to the committee this morning. Charles.

STATEMENT OF CHARLES M. TUREEN, CHAIRMAN, TAX ADVISORY GROUP, NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS AND PRINCIPAL, BLUMFELD, SANDWEISS, MARX, TUREEN, PONFIL & KASKOWITZ

Mr. **Tureen**. Thank you, Congressman Gephardt. Mr. Chairman and members of the committee, my name is Charles M. Tureen. I am a member and principal of the law firm of Blumfeld, Sandweiss, Marx, Tureen, Ponfil & Kaskowitz in St. Louis.

I'm appearing this morning on behalf of the National Association of Industrial and Office Parks as chairman of its Tax Advisory Group. NAIOP represents approximately 7,500 individuals actively engaged in owning, operating, and financing income producing office buildings and industrial properties. My practice is primarily in the area of Federal taxation of real estate transactions and structures.

That area of our joint statement which I will address this morning concerning the administration's proposal is first, the argument put forward that including real estate in the proposal would create tax complexity and second, the discriminatory aspect of the administration's proposal with regard to real estate. The negative effects that the proposal would have in attracting investment capital for real estate are magnified when added to the already discriminatory tax rules affecting real estate which were enacted in the Tax Reform Act of 1986.

Let me begin by addressing the so-called complexity issue. I must admit that I chuckled to myself thinking about what the administration has stated: that is, that including depreciable real estate within its proposal would be a matter of great complexity because of the need to revive rules to recapture some prior depreciation.

First of all, worrying about complexity in the present context of the tax bill sounds sort of funny to me, as if the current laws are simple. A lot of our clients who are getting double billed by their accountants because of the complexity in filling out the tax returns would find the administration's concern rather shallow. I can also say that my hours have increased somewhat because of the recent tax changes designed to simplify the law.

Rules requiring the recapture of depreciation upon property sale have been in the tax laws for over 28 years. I don't know that it's ever been a problem in so far as complexity. We have lived with the rules, comprehended them and complied with them. In fact, the recapture rules were left on the books in 1986 when the capital gains exclusion was repealed just in case, at some point in the future the exclusion was reenacted. The mechanism is still there and those of us who would be subject to the rules do not consider them complex. One further point about complexity, the administration hides behind a false complexity claim on recapture yet ignores the very real complexity which would be necessary in preparing regulations to deal with the allocation of gain between land, which qualifies for the lower capital gains rate, and depreciable aspects, which are excluded from the proposal. Also, a blizzard of regulations would be necessary to try to stop the likely conversions of depreciable real property to securities in order to take advantage of the 15-percent capital gains tax rate.

I just don't think the complexity of including depreciable real property in the administration's proposal is any greater than the complexity created by denying capital gains treatment to depreciable real estate. In any event, the recapture rules we know and the necessary allocation rules we don't know.

The other aspect, which is incredibly serious to NAIOP and to this entire industry concerns section 469, the passive loss rules. Under those rules, there was an effort to equalize passive investors in real estate with passive investors in stocks and bonds. This attack on pure tax shelters has not been all bad for the industry.

The rules went much further than simply attacking tax shelters however. These rules also have had the effect of being incredibly discriminatory against those who are involved in the real estate industry as their line of business. I am speaking of active developers and others who make their living by earning developing fees, management fees, commissions, and such as they put together a piece of property.

People in other businesses can materially participate in their business, such as a factory for instance that manufactures widgets. Therefore, any losses attributable to the depreciable property owned by that particular widget factory can be offset against the income earned from the sale and manufacture of the widgets.

The developer of real estate really is no different and should not be treated differently. The developer is manufacturing rental square feet. That's his factory. He builds that factory. He earns income from a development fee, from management fees, from commissions, and if the project is successful, from the rents that are generated from the building. However, he is not permitted to take any losses from rental property because the passive loss rules deny him the ability to materially participate in a rental property.

This illogical tax rule is having a very significant effect on the entire real estate industry. I like to believe that it was an unintended discriminatory situation with regard to those who are involved in the industry.

So where the real estate developer was in a situation where he would be able to offset losses from a project against other real estate income, he now pays his tax on the income and his losses are suspended to another day.

Now, with the administration's capital gains proposal creating yet another disincentive to invest in real estate, there is no reason for anybody to come forth with the necessary equity capital to permit the developer to go ahead with his project. I think we can say that development loans might be anywhere from 50 to 75 percent of the cost of a project, which means that 25 percent of the cost of a project has to be raised elsewhere.

If the administration proposal was to go through as it is, there is no reason on Earth why anybody would put a dime into real estate because the returns are lower and the risks are greater. Further, don't forget that real estate does not have a liquid market like stocks and bonds. Together, these facts—discrimination under the passive loss rules, lower relative returns because of the administration's capital gains proposal, a naturally risky investment and no ready market—would greatly distort otherwise economical decisions and drive investments in an uneconomical way. This result would be exactly contrary to the 1986 act goal of placing investments on equal economic footing.

Figures that the National Association of Industrial and Office Parks have projected and which we will make available to the committee, indicate that there is a 1-percent annualized, after tax rate of return advantage for an investment in stocks over an investment in real estate as the law now stands. If the administration's proposal were to become law, that differential would be 3 percent per year.

That particular gap would make an investment held in stocks over real estate a cumulative benefit of 15 percent if held for 5 years, 31 percent for 10, and 50 percent for 15 years. Why in the world would anybody want to invest in real estate? There is no reason.

We have not requested a capital gains tax cut. We are not supporting the administration's bill. What we are requesting is that should this proposal move forward, do not discriminate against real estate in favor of stocks and bonds. It's another bullet aimed at investors and full-time real estate businesses who are not tax sheltering but seeking a competitive, economic rate of return. We will be coming back to you with a proposal for remedial legislation to rectify this gross inequity that now exists under section 469 and we would prefer to correct that discrimination and treat all investments equally for both passive loss and capital gains purposes.

Thank you very much for the opportunity to address you this morning.

[The joint statement follows:]

STATEMENT

TO THE

HOUSE COMMITTEE ON WAYS AND MEANS

REGARDING

THE CAPITAL GAINS TAX PROPOSAL

CONTAINED IN

THE ADMINISTRATION'S FY 1990 BUDGET

SUBMITTED BY:

THE BUILDING OWNERS AND MANAGERS ASSOCIATION, INTERNATIONAL
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
THE NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS
THE NATIONAL REALTY COMMITTEE

April 13, 1989

I. INTRODUCTION

A. Organizations Submitting Statement

Mr. Chairman, this statement is being submitted to the Committee on Ways and Means on behalf of the four national real estate organizations which primarily represent those individuals and firms that develop, own, operate, and finance income-producing real estate. These four organizations are and the witness for each is:

○ **The Building Owners and Managers Association, International (BOMA)**: BOMA is the oldest and largest trade association representing the office building industry, with 100 Federal Associations in the United States, Canada, and around the world. BOMA has 6,800 members who are office building developers and owners and managers who own or manage 5 billion square feet of office space in North America. BOMA is headquartered at 1250 Eye Street, N.W. Washington, D.C. (202)289-7000.

The BOMA witness today is Mr. Michael Shehadi, Group Senior Vice President of Charles E. Smith Companies here in Washington and a member of BOMA. Mr. Shehadi is also Vice Chairman of BOMA's National Advisory Council.

○ **The International Council of Shopping Centers (ICSC)**: ICSC is the trade association of the shopping center industry. Members of ICSC, consisting of shopping center developers, retailers, investors, managers, and others having a professional or business interest in the shopping center industry, are engaged in the day-to-day activities of designing, planning, construction, managing, financing, developing, leasing and owning shopping centers and their retail stores. ICSC has approximately 27,000 members, and the approximately 25,000 located in the United States represent a majority of the shopping centers in this country. ICSC is headquartered at 665 Fifth Avenue, 11th Floor, New York, New York. (212) 421-8181.

The ICSC witness today is Mr. Wallace R. Woodbury, the Chairman of the Board of the Woodbury Corporation of Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. Mr. Woodbury is Chairman of ICSC's Government Affairs Committee.

○ **The National Association of Industrial and Office Parks (NAIOP)**: NAIOP is a professional organization of nearly 7,500 individuals engaged in owning, managing and developing office and industrial buildings in the United States and internationally. NAIOP members include not only the nation's leading commercial real estate developers but also architects, brokers, master planners, engineers, property managers, banks, insurance companies and other real estate financial groups. NAIOP is headquartered at 1215 Jefferson Davis Highway, Suite 100, Arlington, Virginia. (703) 979-3400.

The NAIOP witness today is Mr. Charles M. Tureen, a principal in the law firm of Blumenfeld, Sandweiss, Marx, Tureen, Ponfil and Kaskowitz, P.C. of St. Louis, Missouri. Mr. Tureen's practice is primarily in the area of the taxation of real estate transactions and structures and other real estate issues. He also serves as the Chairman of the NAIOP Tax Advisory Group.

○ **The National Realty Committee (NRC)**: NRC represents the nation's leading developers, owners and financiers of income-producing real property. Its members include individuals and firms that design, plan, develop, lease, own, operate and finance income-producing real property, including office buildings, shopping centers, industrial buildings, warehouses and apartment buildings. NRC is headquartered at 1250 Connecticut Avenue, N.W., Suite 630, Washington, D.C. (202) 785-0808.

The NRC witness today is Ellen V. Sigal, Chief Executive Officer, Sigal/Zuckerman Company, a Washington, D.C. based real estate development firm. Ms. Sigal serves as a member of the Board of Directors and Executive Committee of the NRC.

B. Summary of Position

We appear jointly today to demonstrate our united opposition to a proposal contained in the Bush Administration's budget package. This proposal would discriminate against investment in real estate by excluding depreciable real property from the proposed capital gains tax rate reduction. Depreciable real property includes industrial buildings, warehouses, shopping centers and other retail facilities, office buildings, apartments and hotels.

The Tax Reform Act of 1986 changed several provisions of the tax code affecting investments in real estate as well as other investments. One change was the increase in the tax rate applied to capital gains. This change affected all assets equally. Other changes made by the 1986 Act, however, applied solely or primarily to investments in real estate. For example, the depreciable life of real estate was nearly doubled and full-time real estate owners, developers and managers were treated as passive investors in rental real estate in all cases under the passive loss rules, unlike full-time participants in other businesses.

The changes made by the 1986 Act that are of most concern to our industry are those that have fundamentally changed the way real property is developed, owned, and operated by distorting investment decisions through provisions that unfairly discriminate against real estate. In this regard, we are preparing a proposal that would allow those who develop, own, and operate rental real property on a full-time basis to establish their material participation and thus be able to offset rental real estate losses against their other income, as is permitted forfull time participants in other industries.

While the 1986 Act provided some salutary benefits to our industry -- including the end of tax sheltering as a motivation for real estate investment -- in many respects it went too far. As a result of market forces and the 1986 Act, we have experienced significant restructuring of real property ownership and a dramatic growth in the number of workout agreements of distressed properties. These changes obviously affect developers and owners but they also have increased the pressure on financial institutions that provided debt capital for real estate development and acquisition.

It is with this background that we are particularly concerned with the Administration proposal because it would further discriminate against investments in real estate.

We have always supported a lower tax rate for capital gains. The reasons cited by the Administration amply justify a lower capital gains tax rate. However, we firmly oppose providing a lower rate for gains for some assets but not for depreciable real property.

Therefore, we strongly urge the Committee to refrain from adding another form of tax policy discrimination against investment in real estate. If the Committee does reinstate a lower tax rate for capital gains, we urge you to include depreciable real estate as a "qualified capital asset" for the following reasons.

> First, the justifications for adopting a lower tax rate for capital gains on corporate stocks and bonds apply with equal force to direct investments in depreciable real estate.
>
> Second, the reasons advanced by the Administration in its budget message for excluding depreciable real estate from the proposal have little or no foundation.
>
> Third, the proposal would significantly increase the relative tax burden on depreciable real property compared to other assets. This would misallocate resources within the economy as investors are induced by the tax system to shift their assets to a less efficient use of capital. This additional unfair bias against real estate would eventually increase the cost of doing business to the users of buildings. Property values would decline and rents would increase to reestablish the natural relationship between the after-tax rates of return on real estate compared to other assets. This in turn would cause a decline in business activity for real estate entrepreneurs and the satellite industries that produce building materials and supplies and services.

Moreover, an additional defect in the Administration's proposal of significant concern to us is its failure to extend capital gain treatment to qualified assets owned by corporations.

II. THE REASONS CITED FOR LOWERING THE CAPITAL GAINS RATE FOR NON-DEPRECIABLE ASSETS APPLY WITH EQUAL FORCE TO DEPRECIABLE REAL PROPERTY

A. Long-range Investment and Competitiveness.

The Administration cites its commitment to maintaining and enhancing American leadership in employment growth and entrepreneurial activity. "A great strength of the American economy has been the rate of new business formation, product and process innovation, and leadership in new and emerging technologies."

Investments in depreciable real property materially improve the productivity of the economy and are as important to our competitive position in the world as are investments in corporate securities.

Buildings that are energy efficient, that provide modern communications and information processing capabilities, and that are safe and comfortable facilitate the effective and efficient performance of activities within the buildings. Investments in modern office buildings assist the work of knowledge-based workers. Investments in industrial space, warehouses, and shopping centers and other retail facilities make the entire production-distribution system more efficient. New multiuse facilities integrate residential units, commercial office space, hotels and retail outlets all in one combined facility, bringing broad segments of the economy together one location, and making it easier for each segment to access the services of another.

The development of high technology office, manufacturing, warehouse and retail facilities help create value that is passed on to tenants who share in the productivity gains from occupying efficiently designed space.

Obtaining the requisite investment capital for these modern commercial facilities requires a long-term commitment of capital which smaller companies that design, manufacture and distribute products within these facilities often are unable to finance. Many new businesses require innovative and technically sophisticated building environments in which to operate. Manufacturing for high technology products often demands strict control of humidity and dust particles. New warehousing facilities must accommodate computerized inventory and shipping controls. The offices of the future that are being built today tie each tenant's employees to each other within the building, and to other facilities around the world. Most non-automotive sales occur in shopping centers, which provide competition and convenience in the final link in the manufacturing-distribution-retail chain.

For these reasons, we believe that investments in commercial buildings should be viewed as an integral part of strategies to increase the competitiveness of our economy and such investments should be treated equally in proposals such as the Administration's capital gains proposal.

In addition, one of the most important investments our society makes is in depreciable real property to provide shelter to its citizens. Over one-third of all american households rent their homes. The Administration's proposal would discriminate against investment in rental housing.

B. Inflationary Gains.

The Administration, in its budget proposal, notes that "even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a 'fictional' element of profit represented by inflation."

Investments in depreciable real property, like investments in other assets such as corporate stocks and bonds, are affected by the impact of inflation.

The inclusion of land in the proposal addresses some of the impact of inflation on real property. However, gain on depreciable real property, which generally represents the predominant part of the value of all real property, also is influenced by inflation. To disregard the inflationary impact on depreciable real property while recognizing it for other assets is arbitrary, illogical, and poor tax policy.

C. "Lock-in" of Investments.

Another reason supporting a reduced tax rate for capital gains is to avoid "locking in" investments. The

Administration cites this rationale in the case of stocks and bonds, but not depreciable real estate. The administration correctly notes that without the "penalty" of paying ordinary rates on the gain from the sale of securities investors will be more likely to trade more freely in those securities.

This rationale applies equally to depreciable real property. Indeed, the "lock-in" of real property may have a more adverse impact on the economy than the "lock-in" of stocks and bonds.

Free alienability of real estate insures that real property is employed in its highest and best use. This is vital to the functioning of an efficient economy. The investment in real estate in the U.S. is such a large percentage of total private domestic investment that any decrease in the efficiency of its allocation can have significant aggregate economic effects.

The administration argues that decisions to dispose of depreciable real property are based on business cycles and the condition of the particular asset and are not particularly sensitive to the capital gains tax rate. We have not seen evidence of this assertion. The disposition of other depreciable property such as equipment may well respond in this fashion because of an inability to preserve the productive capacity of the equipment through substantial reinvestment or the limited value and gain on disposition.

However, the disincentive to dispositions of real property because of the relatively high rates of tax (Federal, State, and local) on gain, and the consequent reduction in the funds available for reinvestment in another structure, is quite strong in some circumstances for owner-operators. The disincentive may be even stronger for lessors, whose decisions on the disposition of their property are more independent of the particular situation of any individual business and more based upon aggregate financial incentives and disincentives.

Real estate provides some of the best examples of the problems associated with "lock-in". For example, "lock-in" may prevent the disposition of a family-owned business upon retirement or at other times the taxpayer needs to reallocate his assets. A more direct effect on competitiveness, however, results from the higher rates of tax on gain which tend to discourage the natural economic evolution of changing use of real properties. For example, old industrial loft space may be converted to residential units and sold, thus freeing up capital to build new industrial space.

D. "Bunching".

"Bunching" occurs when gain, both real and inflationary, that has accumulated over several years is taxed in one year. This pushes the income of the taxpayer, including the income that otherwise would have been taxed at a lower tax rate, into a higher tax bracket in that year.

The "bunching" problem typically is more severe the longer the holding period because more years of accumulated gain are taxed in one year. Investments in real estate typically are held for longer periods than investments in corporate stocks and bonds. Therefore, bunching is a more serious problem for real estate than for the securities that are included in the Administration's proposal.

In addition, the "bunching" problem is more widespread the greater the number of investors who would be in the 15 percent tax bracket except for a single sale with significant gain. Investments in real estate are more evenly distributed by income class, and therefore by tax bracket, than investments in securities, according to a 1983 Federal Reserve Board study. Therefore, "bunching" is a more widespread problem for real estate than for securities.

In general, the "bunching" problem has been somewhat reduced by the adoption of the flatter tax rate system with 15 and 28 percent rates. However, "bunching" under the new rate system can affect lower-income taxpayers more severely than under the old multiple-bracket system. The new 33 percent surtax may push all of a taxpayer's income from the 15 percent bracket into the 28 percent bracket when a large amount of gain is subject to a tax in a year.

III. REASONS FOR EXCLUDING REAL ESTATE FROM THE PROPOSAL

We are particularly compelled to respond to the reasons cited by the Administration for its decision to exclude investments in real estate from the lower capital gains rate proposal. The budget message cites three major reasons: the lack of justification for inclusion of section 1231 property; the tendency to make investments in tax shelters more attractive; and the necessity to avoid complex recapture rules. These arguments do not stand up to careful scrutiny.

A. Lack of Justification for Section 1231 Treatment.

Section 1231, which the Administration proposes to effectively repeal, is a tax provision of long standing which continues to be justified.

From 1942 to 1987, land and depreciable real property used in a trade or business (section 1231 property) were accorded net capital gain and net ordinary loss treatment. In 1987, the reduced tax rate for capital gains was ended for all types of eligible property. During the two-year consideration of the 1986 Act, there was no debate on repealing the differential treatment of gain and loss under section 1231 and no suggestion that the gains on section 1231 property should be treated differently than the gains on other capital assets. Thus, for 47 years neither the Congress not the Treasury sought to repeal section 1231, even through the major revisions of the Code in 1954 and 1986.

In addition, net capital gain and ordinary loss treatment for section 1231 property continues to be justified on tax policy grounds. Gains on the sale of depreciable real property should continue to receive the same treatment as gains on the sale of stock and bonds. Both are long-term assets which are similarly important to competitiveness and similarly affected by inflation, the "lock-in" effect, and "bunching". In addition, identical treatment of gains avoids distorting investment decisions.

Losses on depreciable real property used in a trade or business should continue to receive the same treatment as losses on other trade or business property. If the taxpayer has net section 1231 property losses, he has, virtually by definition, been involved in a "trade or business" failure and should be able to deduct his business losses without limitation.

Section 1231 treatment of both depreciable and real property used in a trade or business also avoids contentious allocations of land and buildings, an advantage lacking in the Administration's proposal.

B. Increased Attractiveness of Tax Shelters.

The Administration has asserted that by extending the lower tax rate to depreciable property, it would "make tax shelter investments more attractive." This is at odds with the facts. The Tax Reform Act of 1986 created multiple disincentives for investing in real estate tax shelters. Depreciable lives for rental property were nearly doubled, the application of the minimum tax was substantially strengthened, numerous construction costs were required to be capitalized rather than expensed, and the deductibility of interest was limited. These would not be diluted by a lower tax rate on capital gains for depreciable real estate. Indeed, the 1986 Act went too far by penalizing the ownership and operation of rental buildings by real estate professionals through its treatment of these businesses as tax shelter investments.

We think it unlikely that providing the same tax rate reduction for investments in depreciable real property as would be provided to other assets would provide an incentive for tax shelter investments in real estate in the face of the restrictions imposed by the 1986 Act.

C. Complexity of Depreciation Recapture Rules.

For a number of years the application of lower tax rates to gains on depreciable real property has been counterbalanced by the requirement that the taxpayer recapture prior depreciation. Now the Administration suggests that these rules are too complex.

Over the years, taxpayers who owned real property have comprehended and complied with various recapture rules developed by the Treasury Department. These rules still are on the books and could easily be invoked with the extension of lower tax rates for depreciable real property. In fact, in 1986 when the capital gains rate was repealed, these rules were left intact should Congress choose to restore lower rates in the future.

The Administration uses the purported complexity of recapture rules as a justification for excluding real estate from its proposal. Yet it has significantly understated the complexity which would be added to our tax system because of the proposed exclusion. For example, hundreds of pages of detailed and complex regulations will be required to address the allocation of gain between buildings and land, since land would be eligible for the lower rate. Even more complex rules would be required to prevent taxpayers from using the corporate form to obtain capital gains treatment for excluded assets and from selling partnership interests rather than the building owned by the partnership.

IV. THE ADMINISTRATION PROPOSAL WILL CREATE DISTORTIONS IN INVESTMENT MARKETS BY PROVIDING A TAX-BASED DISINCENTIVE TO INVESTMENT IN REAL ESTATE.

The Administration suggests that because real property owners can claim depreciation deductions each year, capital gains treatment on disposition (even with the application of the recapture rules) provides excessive tax benefits to depreciable property compared to nondepreciable property and, thereby, would bias investment toward depreciable property.

However, the most serious problem with the Administration's proposal is the current tax bias it would exaggerate in favor of investors in stocks and bonds and against investors in real estate. Under current law, with 50 percent leverage and a five-year holding period for both stocks and real estate, there is an advantage of 1.1 percent annualized after tax rate of return for an investment in stocks over an investment in real estate. The Administration proposal would increase this bias to 2.9 percent. Thus, the Administration's proposal would create a substantial benefit for investors in stocks compared to investors in real property.

The Administration's proposal also would create a bias toward corporate ownership of depreciable real property. The gain on the sale of their stock, which is derived in part from ownership by the company of real property, will be eligible for the lower tax rate but the direct owner of real property will be taxed at ordinary tax rates.

The ultimate loser in this tilting of the playing field will be the U.S. economy. The goal of the 1986 Tax Reform Act was to create a level playing field for all forms of investment that permits a fair competition for capital in the marketplace. This is an environment in which entrepreneurs in the real estate business seek to compete. Competition helps produce a more efficient allocation of assets in our industry and tends to favor the entrepreneurs who are creating new value and bringing new savings to their tenants.

We therefore urge the Committee not to enact a reduction in the tax on capital gain that discriminates against investments in real property.

Mr. **Gephardt**. Thank you very much. And thank you, the entire panel for very excellent testimony. Mr. Archer?

Mr. **Archer**. Thank you, Mr. Chairman. Mr. Tureen, since you just completed your excellent testimony, in my opinion, I guess it's like the idiots and the holder, but I think it was very beautiful. I applaud you for bringing to the attention of this committee the highly discriminatory effect of the 1986 act. I happen to oppose that act, so I guess maybe I'm a little biased in that regard.

Clearly, one of the jobs of this committee should be to reform the provisions relative to real estate that are so highly discriminatory, as you pointed out. I, for one, also hope that when we consider capital gains that we will include depreciable property along with the other types of assets that are in the present proposal. In other words, I think we should go back to the traditional definition of what is capital and what should get the benefit of capital gains treatment.

I sincerely hope that this committee will do something on capital gains. There are a number of the members who have expressed opposition to any reduction in the capital gains rate. I think that's unfortunate, but we'll have to fight that battle out.

Because you've talked about how we should tax capital gains, I would like to ask your opinion as to how we should tax capital losses. I happen to believe there are great inequities in the code relative to the treatment of capital losses. I would hope that you would encourage this committee to permit the taking of a capital loss on the sale of a home against ordinary income inasmuch as capital gains and ordinary income are treated the same under the code today, and not limit it to $3,000 per year as is presently the case.

Mr. Perlman, coming from Houston, as I do, knows a lot of our people down there who have taken losses on their homes. They have no way to take any tax deduction with respect to this loss. And if you would like to comment, I'd appreciate it?

Mr. **Perlman**. Thank you, Congressman Archer. You're right on target. One of the big impacts in Houston and Texas has been the devastation that people have experienced in the marketplace in losing their homes and not being able even to deduct that loss from any income that they have. That has just absolutely compounded the situation in our hometown. I think that you are absolutely on target, and I thank you for those comments.

Mr. **Archer**. Thank you.

Mr. **Gephardt**. Mr. Moody.

Mr. **Moody**. Thank you, Mr. Chairman. I thought it was excellent testimony. I appreciate the presence of Norman Flynn of Madison, WI here.

Nice to see you. Certainly the realtors in Wisconsin have been very thoughtful participants in the public debate on tax matters and I know they will continue to be.

I was in another meeting I could not miss. I didn't hear your verbal presentation, but I have read your statement carefully, Norman. I was particularly interested in the distributional effects. I had not realized until your paper pointed out that the President's proposal would actually disadvantage middle-income people relative to the top 1 or 5 percent of the upper-income folks. Do you want to elaborate a little bit on that? I think it's important to elaborate that into the record.

Mr. FLYNN. I did, in the verbal testimony, speak to that issue. We do think that the President's proposal is regressive because it does benefit the upper third of the income population, the households with incomes between $30,000 and above $150,000 and, frankly, disadvantages the lower two-thirds, so that if you include depreciable real estate, you get a more even distribution of that benefit across all income streams.

So, if we want to be less regressive and more progressive, if we want to be more equitable, then we'll add the nonhome real estate in the capital gains exclusion area.

Mr. MOODY. Or even if we didn't say to be more progressive, merely to be more nonregressive, simply to be proportional would be——

Mr. FLYNN. Exactly right.

Mr. MOODY. Yes.

Would all of you agree that if the President's proposal was enacted, investment in depreciable real estate would be less attractive relative to financial and certain other investments and therefore the capital value of those assets, since they're substitute competitive assets for people's savings, would tend to fall relative to the value of stocks, bonds, et cetera. Would all of you agree with that?

Mr. FLYNN. Definitely.

Ms. SIGAL. Absolutely.

Mr. MOODY. There would be a windfall loss to owners of depreciable property through the market mechanism since various capital assets are substitute ways of holding value among savers. This would, I assume, hurt not only those holders of those assets but also would confer a comparable windfall gain if people happen to be lucky enough to be holding the liquid forms of assets at that moment of enactment. So, there would be windfall effects on both sides.

Can anyone explain to me what positive public policy benefits might be derived by a series of windfall effects, one negative namely to holders of depreciable property, and one positive windfall set of gains to people who hold nondepreciable real estate property? Is there any public policy this group can conceive of?

Mr. WOODBURY. Mr. Moody, there's one other aspect of the administration's proposal that we really didn't comment on that's related to your point. In the area of securities, there's an established market and when you get to the point where you have a loss or where it's advantageous to dispose of a property, you typically can do so overnight. Whereas in the real estate market, as the Texas people well know, finding a buyer can be a real critical problem. That's an additional marketing disadvantage that further causes a disintermediation.

Mr. MOODY. So you not only suffer a windfall loss of some undetermined magnitude, but no question we know what direction that force would be in. But then you're stuck with a less than fully liquid asset.

Mr. WOODBURY. Right.

Mr. **Moody**. In certain regions of the country, it's very illiquid because the market demand is not there, unless you're willing to drop your price below even what this effect would cause you to drop it.

Mr. **Woodbury**. The FSLIC situation is one of the best evidences of that problem.

Mr. **Moody**. Right. So, the President's proposal would alter the relative after tax rate of returns on assets differently from what they are now?

Mr. **Flynn**. Substantially.

Mr. **Moody**. Yes. Can you tell us, in addition to anything you've already said, what negative effects you feel would be on the economy or on economic growth in our society by that set of side effects of the President's proposal?

Mr. **Perlman**. If I may add, one of the national disgraces we have is the homeless in this country. The homeless person today is not the alcoholic that we see on the street or the drug addict. The homeless person is now the single woman with children who has lost her job and cannot afford to pay her monthly rent.

The Tax Reform Act of 1986 had a devastating effect on low income rental property. And unless we provide incentives for builders to produce low income rental property, we're going to continue to have the homeless walking the streets of this country.

Mr. **Moody**. Any other members like to add a point?

Yes, sir, Mr. Flynn?

Mr. **Flynn**. A very serious FSLIC problem which I know is facing Congress here and predominates, in fact, a lot of your deliberations, 300 billion dollars' worth of properties. If one were to pass or adopt a tax policy which skews capital formation—I think that's the point he was making with the yields, that it would skew capital formation—that would then go to bonds and stocks as opposed to real property, the available capital for that bailout of those $300 billion of foreclosed properties, you'll see those property values decline and diminish even greater, which will then increase the burden upon the taxpayers back and your resolution of that major problem.

Mr. **Moody**. So it will have a magnifying effect on the FSLIC problem.

Mr. **Flynn**. Tremendously magnifying because capital will flow away from real estate and flow into the stock and bond market.

Ms. **Sigal**. In my testimony I tried to address the jobs in our industries. There are not just jobs for Harvard MBA at $100,000. I'm talking about building maintenance engineers, people that run and maintain our buildings, people in construction and related industries, as well as people in small- to medium-sized real estate firms. For smaller firm it's impossible to compete. They're being driven out of this industry. They cannot keep up. I mean you're creating an industry of giants.

Mr. **Moody**. OK, anyone else? Well, thank you. I don't find any disagreement then on my point, which I didn't see in the testimony, that this proposal by the President, if enacted, would set up a series of windfall losses because you cannot immediately dispose of what you have. There would be a windfall effect both in favor of one set of asset holders and very much in the disfavor of holders of depreciable property.

Thank you very much. Thank you.

Mr. **Gephardt**. I want to thank the entire panel for taking your time and effort to come here today. We appreciate very much your testimony. Thank you.

The next panel is Mr. O'Brien, Mr. Ture, Mr. Pechman, and Mr. Satagaj. The committee welcomes our guests and very much appreciate your willingness to take the time and effort to come here today and speak with us. All of your testimony will be made a part of the record and we would now appreciate your statements.

We'll start with Mr. O'Brien, president of the Securities Industry Association. Welcome.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. **O'Brien**. Good afternoon, Mr. Chairman. I'm Edward I. O'Brien, president of the Securities Industry Association.

The securities industry welcomes proposals by the President and Members of Congress to restore incentives for equity investment. We also thank this committee for holding these hearings and for the opportunity to participate in them.

The testimony at these hearings demonstrates that diverse sectors of the Nation's business community agree on the need to reduce capital gains taxes. The U.S. savings rate has reached its lowest point in 40 years. Even worse, investors, particularly individual investors, have fled the equity markets. The causes of these trends are clear and so are the consequences.

Two and a half years ago, Congress sent an unmistakable, though unintended message to investors. For the first time in the adult lives of investors, dissimilar investment choices are taxed identically. There is no inducement to takes risks. There is no recognition that gains are partially inflationary.

Capital gains taxes increased 40 to 65 percent for some taxpayers. For others, taxes nearly tripled. Capital losses remain restricted. The response has been perfectly logical and predictable. Investors are out of the equity markets and into income producing investments offering attractive yields and little risk. At the same time, our trading partners have double digit savings rates several times U.S. levels. But then no industrialized nation treats savings and especially equity investment as harshly as the United States.

Our written statement presents the international comparisons. Higher capital gains taxes increase the cost of capital. They put U.S. firms at a competitive disadvantage in a global marketplace. They increase reliance on debt. Both our domestic economy and our international competitiveness are damaged. Opponents of restoring capital gains tax incentives usually make two claims. First, it only helps the rich, and second, that it costs too much. Both claims are wrong in our opinion.

Many Americans who have capital gains are of modest income. Others of middle income in the years before and after the sale of assets are deemed wealthy by statisticians. That is because the sale of a home, a farm, a business or a retirement portfolio built over a lifetime appears to make them one time rich in the year they realize gains. The majority of individuals realizing capital gains have recurrent annual incomes under $60,000. The medium income of stockholders is about $40,000. To be sure, upper-income groups have discretionary income which could provide capital formation. They can also choose to channel their funds to safe liquid investments.

But it is not just the wealthy who invest or have capital gains, nor is encouraging equity investment too expensive for the Nation's budget. In fact, we may not be able to afford not to encourage it.

Estimating the revenue impact of changes in capital gains taxes is difficult. Thus, you face two opposing Government estimates and a range of private estimates of the effect of the President's proposal. Nearly all of the estimates indicate that cutting capital gains taxes will increase revenues initially. Actual experience supports that view. The patterns following both the increases and the reductions of tax are consistent. What's more, experience shows that revenue gains are a sustained rather than a one time effect of cutting capital gains taxes.

Beyond that revenue effect, we have seen the impact changes in the capital gains tax have on the economy. In the early 1970's, after tax increases, investment capital dried up. For initial public offerings of small companies, it nearly disappeared. But the cuts in capital gains taxes in 1978 and 1981 reversed and erased those negatives.

The current capital gains proposals are not perfect. Some exclude corporate investors for no apparent reason. Some exclude selective capital assets. In an effort to foster long-term investments, some plans extend the holding period to lengths which inhibit investment. Other plans adjust for inflation, but they don't encourage risk taking.

These plans are a good start. We offer to work with you to perfect them and we urge you to restore capital gains incentives.

Thank you, Mr. Chairman.

Mr. Moody [presiding]. Thank you very much, Mr. O'Brien.

[The statement of Mr. O'Brien follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
TO THE COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES
April 13, 1989

Mr. Chairman and members of the committee, I am Edward I. O'Brien, President of the Securities Industry Association (SIA). SIA appreciates the opportunity to comment on the President's proposal to lower the tax rate on capital gains to a maximum of 15%, among other changes to the current tax treatment of capital gains.

SIA represents about 585 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types -- investment banks, brokers, dealers and mutual fund companies as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a unique position to recognize the impact of tax policy on investment and financial decisions by corporations and investors.

Savings, Investment & The Economy

In recent years, the personal savings rate in the U.S. has been on a downward slide to the lowest levels in three decades. That slide in and of itself would be cause enough for concern. However, when the double-digit savings rates of our major competitors are factored in, a formula for decreasing U.S. economic competitiveness emerges.

The savings rate did not even reach 5% in the past 4 years and was at a paltry 3.2% in 1987, the lowest rate since 1947. By comparison, in the 1980-87 period, the Japanese had a personal savings rate that averaged 16.8% and the West Germans, 12.3%. A high rate of savings and investment translates to productivity gains and economic growth through higher fixed investment. The ratio of gross fixed investment to GNP averaged over 20% in Japan and Germany in the 1980-87 period, while that in the U.S. averaged about 15.5%. The low personal savings rate in the U.S. coupled with government deficits bodes ill for future trends in investment, productivity, and competitiveness.

In examining the causes for the disparities between the U.S. and its major international competitors, savings and tax incentives are one place to begin. The 1980s overall have seen some targeted savings and investment tax incentives come and go and some, simply go; i.e., IRAs for most individuals, the dividend exclusion and the capital gains exclusion. The 1986 legislation eliminated targeted incentives for individual equity investment -- the risk-taking so necessary to fuel new and developing companies. The tax code's bias against equity is a long-standing one -- corporate interest paid is fully deductible while dividends are subject to a double tax. The elimination of the capital gains exclusion compounded and exacerbated that bias. With all investment income -- interest, dividends and capital gains -- put on an equal tax footing, investors prefer current income over the promise of future returns and shy away from investments which entail risk. Those investments incorporating risk must offer higher after-tax returns to attract funds.

Taxes are an important element in determining the cost of capital. The increase in the capital gains tax rate in the 1986 tax act increased the cost of capital in the U.S. Higher capital gains taxes diminish the return on investment. Even before the increase in the capital gains tax, the cost of capital in the U.S. was higher than in several of our major foreign competitors. A 1983 study by the International Trade Commission estimated that the cost of capital for U.S. companies was about 16.6%, compared to about 9% for Japanese and West German companies. Higher taxes on capital contribute to differences in the cost of capital between the U.S. and some foreign countries.[1] This differential puts U.S. firms at a competitive disadvantage in the evolving global economy. A lowering of the capital gains tax rate would improve the ability of U.S. firms to attract equity capital and to compete successfully internationally.

The 1986 tax act contained the largest increase in capital gains taxes in history; a 65% increase for investors in the top tax bracket and an even greater increase for some middle income investors. Prior to 1987, the taxation of inflationary gains, the double taxation of corporate income, and the capital loss limitation -- factors that can act to deter investment -- were mitigated by the capital gains exclusion. Thus, the elimination of the exclusion added a heavy weight to the bias against long-term equity investment.

Capital gains are the primary return on long-term investments, with much of the gain simply the result of inflation. Our experience is that most investors consider it unfair to tax long-term capital gains without considering the inflation component. Inflation erodes investors' "real" gains, but the tax code does not distinguish between nominal versus "real" capital gains. For example, a $100 investment in a NYSE stock at the end of 1980 that enjoyed the same rise as the NYSE common stock index would have appreciated by about $78 at the end of 1987. However, about $38 of the gain would simply keep pace with inflation and almost $22 (28% maximum tax in 1987) would be paid in capital gains taxes, leaving the investor with a "real" gain of about $18 or a return of only 2.6% for each year the investment was held. If the company paid dividends, the return could average between 5% and 5.6%. And, this was during a period when we were enjoying rising stock prices.

The current return from equity investment, dividends, is subject to both a corporate and individual tax. A capital gain on that same investment, to the extent the gain stems from the reinvestment of corporate income, is also taxed twice, at the corporate and individual level. In addition, the limitation on capital losses is both asymmetrical and inequitable. Although the full amount of capital gains are taxed as ordinary income, those investors suffering net capital losses remain limited to only $3,000 in deductions against ordinary income annually.

International Comparisons

The comparably harsh treatment of capital gains in the U.S. may be taking its toll on the relative size of our equity market. Measured in terms of equity market capitalization, the premier position of the U.S. has been lost in recent years. In 1980, the U.S. held one-half of the total market capitalization of all exchanges. Even at year-end 1985, the U.S. still claimed a 49% share of world stock markets. The Tokyo stock market has surpassed the New York Stock Exchange as the world's largest stock market. Moreover, the U.S. share of world market capitalization has dwindled sharply. By year-end 1988, the U.S. share of world equity markets sank to a mere 30%. The 67% increase in the size of the U.S. market from $1.2 trillion in 1980 to about $2 trillion by year-end 1988 was outpaced by the 160% gain in markets around the world.

A comparison of the tax treatment of capital gains on individual portfolio stock investment in major countries augurs poorly for any improvement in the standing of the U.S. in the world marketplace. It is indeed ironic that the U.S. can claim among the lowest rates on earned income and among the highest on investment income. Among ten major foreign countries, Belgium, Italy, and the Netherlands do not tax capital gains at all, and Germany does not tax long-term gains (holding period of six-months).[2] Prior to this year, all gains on stocks were exempt from tax in Japan also. Japan's tax reform plan, effective in 1989, will give investors a choice of a 1% sales proceeds tax or a 20% net capital gains tax.

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[1] Economic Report of the President. Annual Report of the Council of Economic Advisers, January 1989.

[2] International comparisons based on preliminary results of an SIA/Spicer Oppenheim study to be completed in June. Final study will be forwarded when available.

Compared with the six countries taxing long-term gains, the U.S. treatment of capital gains is among the harshest of the major industrialized countries. Canada, France and Sweden tax long-term capital gains at rates ranging from 16% to under 20%. While Australia and the U.K. have higher statutory long-term capital gains tax rates than the U.S., substantial exemptions and indexing of the cost basis result in more favorable tax treatment of capital gains by these two countries than in the U.S.

In one of the fastest growing areas of the world, most countries exempt capital gains from taxation. Hong Kong and four of five Pacific Basin countries do not tax capital gains. Indonesia taxes both long- and short-term gain at a 35% rate. However, for long-term gain on securities, the effective rate varies depending on several factors but is lower than 35%.

TABLE I

Summary of Individual Taxation of Capital Gains on Portfolio Stock Investment

Countries	Maximum Short-Term Cap. Gain Tax Rate	Maximum Long-Term Cap. Gain Tax Rate	Period to Determine Short- Or Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States	33%	33%	One Year	None
Australia(A)	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada(B)	19.33%	19.33%	None	None
France(C)	16%	16%	None	1.1%
Germany(D)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan(E)	20%	20%	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden(F)	42%	16.8%	Two Years	3%
United Kingdom(G)	40%	40%	None	None
Hong Kong	Exempt	Exempt	None	None
Indonesia(I)	35%	35%	One Year	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan(J)	Exempt	Exempt	One Year	None

Note: These are preliminary results of a study by SIA/Spicer Oppenheim to be completed in June. Details will be provided on special situations affecting the taxation of capital gains in the final study. Conversion of exchange rates as of 4/7/89. State, local and provincial taxes not included.

(A) Long-term capital gains from assets acquired prior to 9/20/85 is tax exempt and cost basis of other assets held more than 1 year is indexed for inflation.
(B) Lifetime cumulative capital gain exemption of $83,857 (Canadian $100,000); $419,287 (Canadian $500,000) for gain on sale of shares in small business.
(C) Exemption for capital gains on sale proceeds of up to $45,518 (FF 288,400).
(D) First $533 (DM 1,000) of short-term gain is exempt annually.
(E) Effective 4/1/89, capital gains tax on sale of stocks or securities. Previously, gain was exempt.
(F) A 60% exclusion for long-term gain produces lower long-term rate.
(G) First $8,480 (5,000 pounds) of gain is exempt annually.
(I) For securities held over 1 year, gain is taxed at an average effective rate which varies depending on several factors, but is generally lower than 35%.
(J) During 1989, the following are tax exempt: (1) all gain from the sale of stock acquired before 1989 (2) up to $366,300 (NT $10,000,000) of gain on stock acquired after 1988, and (3) 50% of the gain on unlisted securities held for more than one year. If these exemptions do not apply, the individual is subject to national income tax at a maximum rate of up to 50%.

Impact of Capital Gains Tax Changes

Past experience is worth repeating. The 1978 and 1981 cuts in the capital gains taxes lead to beneficial economic consequences. Lower capital gains taxes stimulated savings and investment and, importantly, increased government revenues in a high deficit period. While economic trends are complex, past reductions in the capital gains tax have helped to move these trends in the right direction -- promoting economic growth.

Given the global competition of today, the economic benefits of stimulating savings and investment, particularly in those ventures which create new technology and new jobs would be worthwhile even if revenues were not increased. Estimates of relatively modest revenue consequences, and conflicting at that, should not take priority over larger, more important issues such as the economic consequences of lower capital gains taxes.

Individual Response

Individual shareownership parallels the rise and fall of taxes on investment income. Shareownership as reported by the NYSE climbed steadily for almost two decades, reaching a peak in 1970 of 30.9 million individuals, or 15.1% of the population. With increased taxes on capital gains in the 1969-77 period, shareownership waned. From 1970 to 1975, shareownership dropped 18% to 25.3 million individuals, or 11.9% of the population. In 1978, Congress substantially cut capital gains taxes. By mid-1980, shareownership rebounded -- and was on an uptrend that continued until at least mid-1985, the latest survey period. At mid-1985, 47.0 million individuals directly owned stock or mutual funds, representing 20% of the population. This figure excludes major forms of other "indirect" shareownership; that is, those individuals who participate in pension plans with huge investments.

Individual Retirement Accounts (IRAs) are an example of a strong tax incentive of the 1980s that was tried, worked and was eliminated. In 1982, with the liberalization of IRA requirements, these accounts were claimed on 12.0 million returns, drawing about $28.3 billion in savings. By 1986, over 15 million returns made IRA contributions of over $37 billion. The 1986 tax act curtailed the tax deductibility of IRA investment for most individuals. In 1987, with the limited availability of the IRA tax deduction, only 7.4 million returns claimed IRAs and the amount of funds saved in these accounts shrunk 62% to $14.1 billion. Clearly, the tax deductibility of IRA contributions was a powerful tax incentive which generated a significant amount of savings.

Table II

Individual Retirement Arrangements
Adjustments to Income

($ in Billions)

Year	Number of Returns	Amount
1980	2,564,421	$3.4
1981	3,415,053	4.8
1982	12,010,038	28.3
1983	13,613,167	32.1
1984	15,232,856	35.4
1985	16,205,846	38.2
1986	15,535,531	37.8
1987P	7,351,364	14.1

Source: Statistics of Income Bulletins

Stock Market

In most years since 1977, the stock market indices have scored healthy gains. Impressive increases were registered in the two years following the 1978 tax act by all indices, but particularly the AMEX and NASDAQ indices which represent the smaller capitalized companies. The stocks of smaller companies generally attract the individual investor hoping for investment return in the form of capital gains. In years of rising markets, the NASDAQ Index has usually outpaced both the S&P 500 Index and the NYSE Common Stock Index. In 1985, for example, all major market indices increased by over 20%, but the NASDAQ Index jumped by over 30%.

Table III

Stock Market Indices

(Percentage Change)

Period	S & P 500 Index	NYSE Common Stock Index	AMEX Market Value Index	NASDAQ Index
1979	12.3%	15.5%	64.1%	28.1%
1980	25.8	25.7	41.3	33.9
1981	(9.7)	(8.7)	(8.1)	(3.2)
1982	14.8	13.9	5.7	18.7
1983	17.3	17.5	N.C	19.9
1984	1.4	1.3	(8.4)	(11.2)
1985	26.3	26.1	20.5	31.4
1986	14.6	14.0	7.0	7.4
1987	2.0	(0.3)	(1.1)	(5.2)
1988	12.4	13.0	17.5	15.4

While more than one factor drives stock market prices, all indices rose in 1986 but at a distinctly slower pace than in previous years. Evidence points to a surge of gain taking and selling by individual investors in 1986. In contrast, the stock market literally boomed through the first nine months of 1987. However, preliminary data indicate a sharp falloff in realizations as investors cut back in light of the increased capital gains tax. While the stock market crash severely undermined investor confidence, it does not fully account for the steep drop in realizations in 1987.

Other data support the observation that individual investors reacted adversely to the increase in the capital gains tax. Since 1986, SIA has reported on trading activity by investor sector in its monthly Investor Activity Report. While the retail sector is a residual category which includes various types of corporate and a small portion of institutional market activity, net share activity (purchases minus sales) by this sector parallels the trend in individual realizations in recent years. In 1986, the data show that the retail/residual sector was a net seller of 1.3 million shares daily of NYSE stocks. At an average price of $38.50 for a share traded, daily realizations for this sector are estimated at about $50 million. In contrast, share activity by the retail/residual sector was a wash in 1987, coinciding with the significant drop in individual realizations in that year.

Initial Public Offerings

Equity investment is particularly important to a new company. Individual investors are significant suppliers of these funds. The investor in IPOs and stocks of small companies foregoes current income such as dividends and interest in the hopes of ultimately reaping capital gains.

After the 1978 capital gains cut, the increased market value placed on the stocks of smaller companies produced a market climate conducive to the initial public offerings (IPOs) of new and emerging companies. The public was willing to provide emerging companies with equity for expansion and investment. In contrast, the increased capital gains taxes in 1969 initiated the almost complete evaporation of the IPO market.

From 1969 to 1975, the number of issues and amount of dollars raised in the new issue market plunged 99%, from 548 issues raising $1,457.7 million to 4 issues raising $16.2 million. In the first half of 1978, only 16 companies went public, raising a meager $64.2 million. When passage of the Revenue Act was imminent in the second half of 1978, 29 companies came to market, raising three times the capital obtained during the first half. From 1979 to 1985, the number of companies going public increased impressively and the amount of money raised soared. In 1986, the number of companies going public peaked at 717 and funds raised jumped to $22.4 billion.

In 1987 and 1988, IPOs raised $24.2 billion and $23.7 billion, respectively. However, 40% of the new funds raised in 1987 and an even larger 75%, or $17.8 billion, of new funds invested in 1988 was for new offerings of closed-end mutual funds. These funds for the most part invest in fixed income instruments or stocks of foreign companies. In other words, only $5.9 billion in 1988 was raised by "traditional" IPOs of small, start-up companies. In general, investors have been hostile to providing equity funds for new start-up companies since October, 1987. The need for tax incentives is all the more important, given shaken investor confidence and the higher capital gains tax.

Venture Capital

Venture capital is a critical link in the process of entrepreneurship, business formation, and small firm expansion through innovative activity.[3] Following the 1969 capital gains tax increase, new funds committed to venture capital firms and, correspondingly, the size of the venture capital pool virtually stagnated in the 1970-77 period. Beginning in 1978, however, venture capital firms were able to raise a significant amount of funds to fuel budding enterprises. Both the total pool of venture capital and the size of disbursements expanded dramatically in the 1980s. In recent years, almost three-fourths of disbursements went to computer, electronics, communications and medical health-care related companies.

Tax-exempt entities (pension funds and non-profit institutions) are a growing source of venture capital. However, the National Venture Capital Association notes that tax-exempt investors provide less than 4% of the risk capital for small, rapidly-growing firms. Individual investors are likely to be the first source of funds for innovators in developing new ideas. In an analysis of capital invested in new-technology firms at different stages of financing, private individuals provided 29% and 31% of the capital for the "seed" and start-up stage as compared to 6% and 22% by venture capital funds.[4]

Revenue Impact

The revenue effect of changes in the capital gains tax rate has been the subject of much debate. Policymakers are now faced with two opposing sets of estimates for the President's proposal. In considering either estimate, however, the revenue impact is minor in comparison to the size of annual deficits. The relatively minimal revenue consequences of a change in capital gains taxes will not have a significant impact on the deficit, but will foster trends that are good for the economy.

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[3] The State of Small Business: A Report of the President, May 1985.

[4] Paper by Dr. John Freear and Dr. William Wetzel, University of New Hampshire, May 1988.

The actual experience since 1978 weighs in on the revenue-raising side. Actual experience has demonstrated that revenue estimates which minimize or ignore individuals responsiveness to tax changes will be wrong. Taxpayer response to lower capital gains taxes is more than an accelerated draining of a static pool of realizations. Rather, realizations usually fund new investments, which in turn can generate new capital gains. In effect, lower tax rates on capital gains impose a smaller tax on redirecting money from existing investments to newer projects with better prospects. Conversely, lock-in due to a high tax rate not only prevents the efficient allocation of resources but lowers Treasury revenues as well.

Prior to the 1978 capital gains tax cut, opponents of the cut argued two main points. First, capital gains revenues would decline because of lower rates and, second, any spurt in gains realized would be a one-time phenomenon, with gains drifting to lower levels by 1980. On both these scores, actual experience has run counter to narrow theory. In fact, significant revenues, which increased each year, were generated by lower capital gains taxes.

Despite the slash in the capital gains rate from almost 50% to 28%, capital gains tax revenues collected in 1979 and 1980 exceeded Treasury projections for those years before passage of the 1978 Revenue Act.[5] Moreover, taxes actually paid on capital gains income continued to increase as the lower marginal rates of the Economic Recovery Act of 1981 were phased in. In 1983, a new plateau was reached, with taxes paid on gains spurting 46% to $18.8 billion from $12.9 billion. By 1985, realizations had increased to $165.5 billion, and the tax-take was almost $25 billion.

The Statistics of Income (SOI) series on sales of capital assets show an almost doubling of asset sales from $67.7 billion in 1985 to $132.8 billion in 1986. So too, estimates of Treasury's capital gains tax revenues show a leap to over $46 billion. The spurt in capital gains in 1986 reflects taxpayers' anticipation of the 1987 increase in rates. Preliminary SOI data for 1987 indicate that sales of capital assets remained at about the same level, $133.5 billion. However, this apparent flat trend is misleading. Individual gain taking actually plunged sharply in 1987.

The SOI series reports capital gains in adjusted gross income; i.e., after the 60% exclusion available in 1986 and prior years. In 1987, the exclusion was eliminated and a maximum 28% rate applied to all gains. Hence, 1986's $132.8 billion of capital asset sales represented about 40% of total realizations of over $330 billion that year, while 1987's sales of $133.5 billion represent 100%. In other words, sales of capital assets or realizations plunged by almost 60% from 1986 to 1987.

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[5] In 1977, the highest taxes on capital gains reached 49.125%, due to the combined effect of capital gains taxes, the minimum tax and the maximum tax.

Table IV

Revenues and Realizations

($ Billions)

	SOI Series	Treasury Series		
	Sales of Capital Assets (net gain less loss)	Total Gains	Taxes Paid on Capital Gain Income	Effective Tax Rates
1977	$20.8	$45.3	$8.1	17.88%
1978	23.2	50.5	9.3	18.50
1979	28.2	73.4	11.7	15.89
1980	30.0	74.6	12.5	16.71
1981	30.8	80.9	12.7	15.61
1982	34.4	90.2	12.9	14.31
1983	49.4	122.0	18.8	15.41
1984	54.5	140.5	21.2	15.41
1985	67.7	166.0	24.5	14.8
1986	132.8	319.0	46.5E	14.6
1987	133.5P	140.0P	NA	NA

Source: Statistics of Income Bulletin and Office of the Treasury, Office of Tax Analysis.
Note: 1987 SOI reported on a different basis; i.e., no exclusion. Tresury data series varies slightly starting with 1985.
P = Preliminary; E = Estimate; NA = Not Available

Given the multitude of variables in any forecast, estimating revenues for even one year is an error-prone art. Historical experience has demonstrated that investor reaction to changes in the capital gains tax rate is significant. The real question for policymakers is whether to encourage capital formation and risk-taking by those individuals who have funds to invest. Importantly, can the U.S. economy continue to grow and compete with a bias against long-term equity investment.

Who Benefits?

Lower capital gains taxes do not benefit just the "rich." Indirect benefits -- expansion and employment financed by equity investment flow to all economic groups and regions of the country. Direct benefits, through capital gains realizations, belong to a wide strata of Americans. For exmaple, based on the latest NYSE shareownership study in mid-1985, the average stockowner had a median income of about $37,000.

A review of the distribution of capital gains (net long-term gain in excess of net short-term loss) in recent years shows a trend toward an increasing concentration in the upper income groups. At the same time, all income groups have been reporting higher realizations in absolute terms. However, this picture of the distribution of gains is static and somewhat distorted.

For some individuals, capital gains are the fruition of a lifetime investment or work effort. With no adjustment for inflation, these individuals are catapulted into an upper income category. For example, the sale of a small business, a taxi medallion, or a house (for those not qualifying for the special exclusion) can make middle-class individuals "rich" for a year in terms of their tax status. Paul Craig Roberts' analysis of capital gain distribution by recurring income, that is without these transitory effects, reveals that 50% of all capital gains go to people earning less than $60,000 annually. Moreover, his analysis shows that three million taxpayers with recurring annual income below $20,000 receive a larger share of total gains than taxpayers earning more than $200,000!

The transitory effect, and its corresponding taxpayer frustration, is aptly summed up by the February 16, 1989 letter of Malvin Cole to the New York Times editor. Mr. Cole's letter is excerpted below.

"I'm not your typical capital gainer... I fall into the 15% tax bracket... I bought raw land 30 years ago as an investment with costs amounting to $25,000. I recently sold it for $150,000... at 33%, the gains tax grabs $41,250, leaving me $83,750 for retirement. The old gains rate of 20% would have taken only $25,000... It would have been smarter to keep that $25,000 in the bank compounding annually..."

Just as it is well to note that lower capital gains taxes need not impact only the "rich", it should be noted that the lowering of income tax rates overall was not a boondoggle for the "rich". Despite lower marginal rates, the growth in the share of taxable income accounted for by the upper income groups has been matched by corresponding growth in income tax liability. For example, in 1980 and 1981, those falling into the $200,000+ AGI group accounted for about 3.0% of total taxable income and paid about 7.5% of total income taxes. By 1985, the share of taxable income of the $200,000+ group had doubled and so had their share of taxes. In 1986, capital gains realizations almost doubled, with much of this jump concentrated in the $200,000+ income group. While this group's share of taxable income spurted to almost 8.0%, their share of income taxes increased to over 20%.

To be sure, upper income groups have discretionary funds which could provide capital formation. Because they also have greater financial flexibility, a "soak the rich" mentality through higher capital gains taxes can result in retarding economic growth. Higher capital gains taxes can be avoided -- investors can choose to "lock-in" or channel funds to safe and liquid fixed income investments, such as Treasury obligations, CDs, money market accounts, or municipal bonds that are exempt from Federal tax. Currently, these investments are offering attractive yields and carry minimal risk. Equity investment is investment in jobs, technology and progress which benefits all income groups. Tax policy should encourage, not penalize, such investment.

A Few Limitations

The case for lower capital gains taxes is strong. On all fronts -- stimulating savings and investment, raising revenues, and putting U.S. investment taxation on a competitive basis with other nations -- the arguments are compelling. A 15% capital gains tax rate would prove beneficial to investors, to government and, ultimately, to the economy. The President's proposal is a welcomed step to reduce the capital gains tax.

There are, however, several facets to the President's proposal which would limit its effectiveness. All investors should have the benefit of lower capital gains taxes. Corporate investment generates the same positive impact as investment by individuals and should therefore be encouraged. In addition, a three-year holding period subjects an investor in corporate stock to considerable risk which may dissuade him or her from making the investment at all. Recent history demonstrates that in three years, an investor could face several reversals of not only the market but government policy as well.

Nevertheless, the President's proposal is an improvement over the current tax system which is void of incentives for equity investment. We urge this Committee to improve the proposal and Congress to enact it.

Mr. **Moody**. Dr. Ture.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. **Ture**. Thank you, Mr. Moody.

Let me offer my commendation to the committee for holding hearings on the subject and on the President's proposal to reduce tax on capital gains.

I very firmly believe that the proposal warrants your very careful attention, not as a revenue raiser, and I think it's regrettable that so much attention has been given to that aspect of the situation, but because there is, appropriately, a very high level of public policy concern about the adequacy of domestic U.S. savings.

I think that reducing the tax on capital gains is an important measure for reducing the income tax bias against saving and in favor of consumption. I can only wish that the proposal for reducing the capital gains tax were not, in effect, standing alone as virtually the only measure that is currently being proposed to achieve this objective of reducing the antisaving bias in our tax system. I think it would be wholly appropriate for the administration and certainly for this committee, and your sister committee in the other chamber, to be developing such a program and giving it very high priority indeed.

The Bush proposal addresses only one of the many provisions in the tax law that have the unfortunate effect of increasing the cost of saving relative to the cost of consumption. Although the proposal, as has been pointed out to you by many of the other witnesses, has several limitations, I nevertheless believe it would be a constructive first step toward reducing the tax-induced extra cost of saving.

I want to focus primarily, and I do in my testimony, on the economic consequences of the present treatment and the benefits that could be obtained by changing that. But the issue that has been raised is who gets the benefit from reducing the tax on capital gains? I don't believe that's an appropriate issue. I don't think that the concern about what's the income level distribution of those who will achieve the greatest reduction in their tax liabilities is really what ought to be at issue. The rightness of the tax treatment should not depend on who gets it, but on what it will do in terms of the neutrality of the tax law.

The truly important issue, in my judgment, and the real concern is to alleviate the adverse economic consequences of the existing tax bias against saving. Those adverse effects are not borne exclusively by those who do the saving. Indeed, to a very substantial extent, they're the minority interest in this respect. The principal group in the population that suffers as a result of that bias are those who obtain their incomes by providing labor services.

A tax bias against saving has the effect of reducing the amount of saving, which results in a smaller stock of capital, therefore a lower capital labor ratio and lower levels of productivity of labor, lower demands for labor services, lower levels of employment, lower levels of real wages than otherwise would be obtained. One might summarize this effect by recognizing that for every dollar of foregone returns for saving, there's somewhere in the neighborhood of $2.00 to $3.00 less in labor income that's realized throughout the economy.

As has been noted by other witnesses, taxing and capital gains has a number of other adverse effects. For one thing, under our present system we tax an awful lot of unreal gains. Indeed, some of those gains that we tax aren't gains in real terms at all, but losses. The tax locks in investment, it immobilizes savings; it, therefore, has a deleterious effect on the efficiency of the capital markets. That contributes, along with a double tax on dividends, to a bias against equity financing and in favor of debt financing.

We need to move, it seems to me, the tax system toward greater neutrality in the tax treatment of saving compared to consumption. The way to achieve that is either by taxing income that is saved while exempting the returns or doing the reverse. That is, exempting income that is saved while fully taxing all the gross proceeds thereto.

Reducing the tax on capital gains would be a modest but important step in that direction. It would reduce the cost of saving with beneficial effects with respect to capital accumulation, the capital-labor ratio, labor productivity, employment, real wages, innovative enterprises, and market efficiency. On those grounds alone, it seems to me, it deserves your most careful attention.

So far as the revenue estimates are concerned, a matter to which a great deal of attention has been given, all of the estimates that I have seen have focused almost exclusively on the so-called transactions effect, that is, what will be the consequences for the volume of transactions and the volume of gains that are realized as a result of reducing the tax rate. Well, I don't disregard that or think it is unimportant. Certainly, it will have an effect that moves in a positive direction. If that were the only effect, I would strongly suspect that the net effect would be negative. That is to say that there would be revenue losses.

But I don't think that's even the single most important effect. One other effect which I think would be extremely consequential is that virtually instantaneously there would be a higher level of market valuations of assets than otherwise would prevail. Therefore, the accumulated gains there to be realized would be larger than otherwise would be the case.

By far the most important effect, both for the short-run and the long-run, but particularly for the latter, would be the increase in the levels of economic activity and the increase, therefore, in the income base to which not only the corporate and individual income taxes but also the payroll taxes would apply.

It seems to me that when you put all three of these effects together there is a substantial probability that reducing the capital gains tax rate will be a revenue gainer rather than a revenue loser.

I would join with some of the other witnesses in urging that many of the deficiencies in the Bush proposal ought to be addressed. In particular, excluding business property from the proposed reduction in capital gains tax rates, it seems to me, is inappropriate, and I didn't see anything in the Bush statement that represented really a solid argument for doing so.

I also think that the proposal to phase in an increased holding period would be counterproductive, both with respect to the revenue consequences and certainly with respect to the desired economic effects.

I thank you very much.

[The statement of Mr. Ture follows:]

THE ECONOMIC EFFECTS OF THE INCOME TAXATION OF CAPITAL GAINS

STATEMENT OF NORMAN B. TURE, PRESIDENT
THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION
TO THE
COMMITTEE ON WAYS AND MEANS

April 13, 1989

Mr. Chairman, members of the Committee, I am pleased to have this opportunity to discuss President Bush's proposal to reduce the tax on capital gains.

Easing the tax bite on capital gains is, I believe, one of a number of steps that should be taken, at the earliest possible moment, to reduce the tax bias against saving and private capital formation. The tax on capital gains is one of the major provisions in the federal income tax that contributes to increasing the cost of saving and of capital formation. Those provisions distort market signals about the best ways for us to use our incomes and our production capability. The resulting losses of our economic well-being are not offset by any gains in terms of fairness of the tax laws or ease of compliance and administration.

The adverse effects of these tax-induced cost increases on the economy's efficiency and growth should be the principal concern in evaluating the President's proposal. These costs of the present tax treatment of capital gains should, I submit, outweigh considerations of the federal tax revenue consequences of reducing the tax bite on capital gains, irrespective of whether reducing the capital gains tax would raise or lower tax revenues.

The Bush proposal for reducing the tax on certain capital gains would be a significant step toward alleviating the income tax bias against saving and investment. The proposal has a number of serious limitations, and it should not be seen as a sufficient measure for dealing with the numerous income tax penalties on saving and investing. Nonetheless, I believe that the Committee should assign a high priority to its enactment, sending a signal to all of us that public policy makers are aware of the anti-saving bias in our tax laws and are determined to reduce, if not totally eliminate, it.

The Income Tax Bias Against Saving and Investment

Saving is the use of current income to purchase a source of future income. The purchase of capital assets is one form of saving, and capital gains are one form in which future income is obtained. A neutral tax system would not impose a heavier tax burden on income that is saved than on income that is consumed. Unhappily, the federal income tax system weighs far more heavily on saving than on consumption; the principal culprit is the income tax imposed on corporations and on individuals, including the tax imposed on capital gains.

The income tax bias against saving and in favor of consumption has been explained in various ways to the Committee over the years, and presumably no lengthy exposition of that bias is needed on this occasion. I find it useful to treat this subject by showing that the income tax raises the cost of saving relative to the cost of consumption and that the greater the amount of taxes imposed under the tax structure on the returns to saving, the greater is the increase in the cost of saving compared with the cost of consumption.

A simple example helps to explain the income tax bias against saving. Suppose an individual earns an additional $1,000. In the absence of taxes, that $1,000 could be used to buy an additional $1,000 of consumption goods and services or it could be saved -- used to purchase assets or claims to assets that will provide the individual with additional income. Suppose the individual would be just indifferent between using it for current consumption or saving the additional $1,000 if by investing it he could get an annual yield of 10 percent, i.e., an additional $100 of income this year and every subsequent year. The cost to him of obtaining that additional future income is the $1,000 of foregone current consumption; each dollar of additional income costs him $10 of foregone current consumption. By the same token, the cost to him of $1,000 of current consumption is the foregone additional future income -- $100 a year every year.

Now suppose a 28 percent income tax is introduced. The individual's $1,000 of additional current income is immediately reduced by the tax to $720. He can now buy $720 of additional consumption goods and services, or he can save the $720 and, assuming the yield on his saving is still 10 percent, he'll get an additional $72 of income every year, pretax. But 28 percent of that $72 of additional income will also be taxed, leaving him with $51.84 after tax. By giving up $720 of current consumption, the individual can obtain only $51.84 of additional future income; each dollar of that after-tax additional income costs him $13.89 of foregone current consumption compared with $10 before the tax was imposed. The 28 percent income tax raised the cost of saving relative to the cost of consumption by 38.9 percent.

This is a significant increase in the relative cost of saving as a result of what may appear to be a moderately low tax rate. This is, however, only part of the income tax penalty on saving. The income tax in the example is a single-layer income tax; in fact, there are two layers of federal income taxes that apply to much of the returns for saving. The income produced by saving invested in corporate equities is subject to the corporate income tax; in addition, the income remaining after the corporate tax is subject to the individual income tax in the hands of the equity owner. If the income remaining after the corporate income tax is distributed to the individual as a dividend, that dividend is subject to the individual income tax. If the after-tax corporate earnings are retained and are reflected in an increase in the market value of the stock, this appreciation in value is subject to the capital gains tax when the individual sells his equity interest.

The effect on the relative cost of saving, even with the relatively low rates of tax now in effect, is dramatic. As a rough approximation, the combined effect of the corporate income tax and of the individual income tax, imposed either on dividends or on capital gains, is to raise the cost of saving relative to consumption by about 110 percent.

The Economic Consequences of the Anti-Saving Tax Bias

Because people respond to changes in relative costs and rewards, they tend to use more of their current income for consumption and to save less of it than they would if the tax system provided neutral treatment of saving and consumption. This lower rate of saving necessarily means a lower rate of capital formation, hence a smaller stock of capital resources than would prevail in a neutral tax climate. Indeed, the stock of capital is sufficiently lower and the pretax return it produces sufficiently higher that the after-tax income available to the saver-investor is the same as it would have been in a no-tax world. In our example, the pretax return has to go up to a bit over 21 percent if the individual is to obtain a net-of-tax return of $72 on his $720 of saving. This implies that the reduction in the stock of capital compared to what it otherwise would be is quite substantial.

The reduction in saving and in the stock of capital resulting from the tax bias against saving reduces the level and rate of gain of labor's productivity compared to what it otherwise would be. The true cost of the tax penalty imposed on saving includes the foregone job opportunities and lost labor income, not merely the loss of the returns for saving.

Moreover, average total costs of production are higher than they would otherwise be. If public policy makers are really concerned about the competitive position of American businesses in the world market place, they should carefully scrutinize the present federal tax system to identify opportunities to change it to reduce the tax bias against saving and capital formation.

Finally, the tax penalties on saving tend to shift the composition of production activity away from capital-intensive to labor-intensive operations. To be sure, the heavy payroll taxes imposed on wages and salaries exert an opposite pressure, although very likely not so severely. In any event, good tax policy should seek to minimize these selective excise effects, not to balance them off against each other.

It is sometimes argued that however severe the income tax bias against saving, the economic consequences are far less adverse than I've suggested because saving is not responsive to the tax-induced increase in its cost. I think this argument is without substance. Consumption and saving fully exhaust one's disposable income. If the amount of one's saving does not change in response to a change in the cost of saving, neither does the amount of consumption change. Suppose the cost of saving falls, that is, one must forego a smaller amount of current consumption to obtain a given amount of future income. Notice that this necessarily means that the cost of consumption has gone up. If one does not increase one's saving in response to the reduction in its cost, neither does one reduce one's consumption in response to an increase in its cost.

Indeed, some who argue that the tax-induced cost of saving is not important claim that people save less when the cost of saving falls and save more when the cost increases. This is the same as asserting that when the cost of consumption goes up, people consume more, and when the cost of consumption goes down, people consume less. The absurdity of the argument should be obvious. It is equally absurd to maintain that the tax bias against saving has little or no adverse effect on saving, on the stock of capital, on productivity, employment, and labor income and on the efficiency with which we use our productive resources.

Requirements for Tax Neutrality

If the income tax is to bear no more heavily on saving than on consumption uses of income, the rewards for saving should not be depressed to any greater degree than those for consumption. One way to achieve this tax neutrality would be to tax the income that is saved but not the returns to saving. In the example, the $1,000 of additional income would be taxed but the returns on the remaining $720 that is saved would not be taxed. The individual, then, would obtain $72 a year in additional income as the reward for foregoing $720 of current consumption. As in the case of the no-tax world, the cost per dollar of future income would be $10 of current consumption. Another way of eliminating the anti-saving distortion would be to defer the tax on the income that is saved and instead assess the tax on the gross returns when they are withdrawn. In the example, the initial $1,000 would be taxed if used for consumption, leaving $720 for that purpose. It would not be taxed if saved, but the $100 of gross return would be taxed, leaving the individual with $72 per year as the return on his $1,000 of saving. In this case, too, the individual would forego $720 of current consumption to obtain $72 more income every year. Each dollar of that additional income would cost him $10 of foregone consumption, just as in the no-tax world.

The latter treatment is provided in the case of qualified pension plans, 401(K) and 403(B) plans and, to a limited extent, by some IRAs. A more thorough approach would be to reform the tax system along the lines of a consumption-based income tax, such as the one that is described clearly and in detail by David Bradford and the U.S. Treasury Tax Policy Staff in Blueprints For Basic Tax Reform (Arlington, Va: Tax Analysts, 1984).

In any case, there is no room in an income tax that seeks to provide neutral treatment of saving and consumption for a corporate income tax or for a tax on capital gains. The capital gains tax helps create the general bias against saving because it is an added tax on the rewards to one form of saving. In short, to help avoid an inefficient anti-saving tax distortion, the capital gains tax rate should be zero.

Additional Injustices And Inefficiencies Caused By Taxing Capital Gains

The taxation of capital gains at the full rate of ordinary income presents a variety of problems. These efficiency and equity concerns probably explain why capital gains have been taxed at a reduced rate during most of the income tax system's history.

An Inflation Tax

Because the tax code measures capital gains in nominal dollars with no adjustment for inflation, a large share of what is taxed as capital gains -- often the overwhelming majority -- does not represent real gains but merely inflation. Suppose, for example, that a person bought $1,000 of stocks in 1965, that the stock rose at the same rate as the Standard & Poors 500 index, and that the person sold the stocks in 1988 for their value then of $3,015. Also assume that the person is in the 28 percent tax bracket, a rate reached by many middle-class taxpayers. Because the nominal capital gain is $2,015, the person would owe a capital gains tax of $564. In real dollars, however, the person did not enjoy a capital gain but suffered a capital loss: $1,000 in 1965 was worth $3,755 in 1988 (based on the Consumer Price Index), $740 more than the $3,015 actually realized on the sale of the stocks. The person in this example had in fact suffered a capital loss of $740 in dollars of constant purchasing power (1988 dollars). It is a harsh tax penalty and a strong deterrent to saving to extract heavy capital gains taxes from people who have suffered losses or meager gains on their investments.

More generally, the capital gains tax overstates the real gain whenever the inflation rate is greater than zero and thus raises the effective tax rate above the statutory rate. This camouflaged increase in tax rates is obviously unfair to savers. In addition, it puts them at special risk should inflation heat up: higher than expected inflation tends to mean that investors will have higher than expected real tax liabilities. The elevated tax rates and added risk understandably increase the cost of saving, and people will respond by saving less, with the adverse economic consequences delineated above.

Many observers thought that one of the functions of the old 60 percent capital gains exclusion was to make a correction, admittedly a very rough one, for this phantom income. Even if capital gains are to continue to be taxed as ordinary income, the goals of justice and economic growth and efficiency make a powerful case that only real capital gains should be taxed; certainly we should not compound the tax bias against saving exerted by taxing capital gains by taxing illusory gains as well.

Anti-Equity Bias

The income tax system's pro-consumption, anti-saving bias inhibits all investments, no matter how they are financed. The corporation income tax adds a second layer of bias against corporate equity investments, as pointed out above. When the investor obtains these after-tax returns, whether as dividends or capital gains, they are again taxed, this time by the individual income tax. Interest on corporate debt, in contrast, is deductible at the corporate level; it therefore encounters only one layer of the income tax bias, instead of two. This difference in tax treatment, accordingly, exerts a greater bias against equity finance than against debt finance. Good tax law would be neutral in its influence on the form of financing business.

The government-induced tilt against corporate equity financing, moreover, also exerts a bias against the corporate form of business organization. Good tax law would not influence the choice concerning the form of organization; the present law does.

A reduced capital gains tax rate would help fight the bias against both the corporate form of organization and equity finance. Reducing the tax on capital gains realized by corporations would also contribute to this objective. Unfortunately, the President's plan affords no reduction in the tax on corporate capital gains. Such gains would still be subject to the 34 percent rate that is more than one-fifth greater than the 28 percent rate that prevailed prior to the Tax Reform Act of 1986 (TRA-86).

Another constructive move would be to reduce the present double taxation of dividends. In the Committee's recent hearings on leveraged buyouts, I urged a reduction in the capital gains tax rate and a partial dividend deduction on net new common stock issues as first steps toward alleviating the tax law bias against equity. I also sought to point out that the wrong way to deal with the anti-equity bias would be to curtail the deductibility of interest. Limiting interest deductibility would violate the fundamental tax principle that a legitimate business expense should not be included in income. Worse, by intensifying the existing tax bias against saving and investment, it would further depress capital formation in the United States, costing us productivity and jobs.

The Lock-In Effect

The capital gains tax discourages investors from altering the composition of their asset portfolios in response to new opportunities or changes in their tastes and needs. Although capital gains tax liability accrues along with the accrual of gains, the actual payment of the tax occurs only when the gain is realized upon disposition of the asset. The tax acts therefore like an excise on transactions in capital assets.

Individuals who want to realize the gains that have accrued on one or more of their capital assets in order to acquire other assets, rather than to finance consumption outlays, find that the capital gains tax raises the threshold of earnings the new assets must provide. The after-tax earnings on the new assets must be sufficiently larger than those on the assets the investor now holds such that the present value of the additional earnings at least equals the capital gains tax to be paid on the gains realized on the sale of the old assets.

This lock-in effect clearly is an artificial constraint on capital asset transactions. As such, it impedes every saver-investor from achieving as efficient a portfolio of assets as he would otherwise hold at every moment in time. By reducing the mobility of saving, the capital gains tax impairs the efficient functioning of the capital market. Market valuations of capital assets are distorted by the tax; relative market values do not accurately reflect the relative productivity with which businesses use their production resources. In brief, the tax induces less than optimum allocation of saving among all the competing capital uses thereof.

In the wake of TRA-86, the lock-in effect is actually a bigger constraint for most savers than it was under prior law. TRA-86 increased the top corporate capital gains rate from 28 to 34 percent; it hiked the top individual capital gains rate from 20 to 33 percent (higher for many elderly savers).

Revenue Effects of a Reduction in the Capital Gains Tax

Most of the public policy debate concerning proposals to reduce the capital gains tax have focused on the federal revenue consequences of doing so. I do not believe, as I stated earlier, that the estimated revenue consequences should be the principal consideration in deciding whether to move positively on the President's proposal. The benefits for the economy to be obtained by reducing the capital gains tax and thereby moderating the tax bias against saving should far outweigh revenue considerations. Nevertheless, given the public concern about the budget deficit, the revenue consequences of reducing the capital gains tax cannot be ignored.

Estimates of revenue effects have come up both positive and negative. For example, with respect to President Bush's proposal to reduce the tax to 15 percent, the Joint Committee on Taxation has estimated a revenue loss of $24.2 billion in the 1989-94 period. Economists at the Treasury Department, on the other hand, have argued that capital gains tax reductions in 1978 and 1981 yielded increases in revenue and that a reduction to 15 percent, in light of the 1986 increase in the rate, would yield a $9.3 billion revenue gain in the years 1989-1994.

The problem with both of these assessments is that they do not consider all of the revenue enhancing features that capital gains tax reduction would include. They narrowly focus on only one, the "transaction response" or unlocking effect. In fact there are three important responses to a reduction in the capital gains tax that could significantly contribute to an expansion of the tax base and tax revenues.

The first and most direct effect on tax revenues of reducing the capital gains tax rate is through a reversal of the "lock-in effect" discussed above, the second is by increasing the value of assets in general, and the third is by stimulating economic growth. The combination of these effects could easily generate a revenue increase for the government.

An implication of reversing the lock-in effect is that gains will be realized more frequently. In the first few years after a rate reduction a surge of capital gains realizations can be expected as assets that were being held simply because of the tax deterrent to realization are sold off. Reduction in the capital gains tax rate will also reduce the incentive of older savers to forego realizations in favor of transferring gain-laden assets by testamentary disposition, thereby affording a step-up in basis of the assets for the heirs. This will tend to increase realizations on a continuing basis, not merely temporarily.

Whether the increase in gain realizations would be sufficient to generate as much tax revenue at the proposed lower rates as the revenue produced by the present higher rates on the realizations that will occur under present law has been at the heart of the debate among Treasury, CBO, and JTC economists. Looking only at this realization effect, one may well be skeptical that the proposed 46.4 percent rate reduction -- from a top of 28 percent to the proposed top rate of 15 percent -- would be a revenue gainer. Just to draw even, realized gains would have to increase by 86.67 percent. Such an increase is not inconceivable, but it is not highly likely. If the only effect of the proposed rate reduction were to unlock accrued gains and increase gain realizations, I suspect the rate reduction would be a revenue loser.

The lock-in effect could also be reduced by eliminating or shortening the holding period. Historically the differential tax treatment of capital gains has applied only to so-called long-term capital gains, those realized on assets held longer than some stipulated period, six months during many of the years in which lower rates applied to long-term gains, and a year or longer during some other years. This is an arbitrary distinction that, in many cases, distorts the timing of asset sales, inducing investors to hold gain-laden assets longer than underlying economic considerations would justify.

The Administration's proposal, unhappily, would exacerbate this problem. After a phase-in period, only assets held for three or more years would be eligible for the reduced rate. This aspect of the proposal should be reconsidered. It is not beneficial to the economy and reduces the revenue-enhancing qualities of the administration's proposal.

Reducing the capital gains tax would also expand the tax base because the lower capital gains tax rate will increase the market value of existing eligible capital assets. Since the market value of a capital asset is determined by the risk-adjusted present value of the after-tax income produced by the asset, a lower tax rate will be reflected in greater capital gains. This effect will occur in both the short run and the long run, resulting in a permanent increase in the tax base relative to what it would be at the higher tax rate.

The third effect, economic expansion, is the most general and potentially the most significant in broadening the tax base. As already discussed, reducing the tax rate on capital gains would benefit the economy most significantly by reducing the tax bias against saving and therefore reducing the cost of capital for the economy as a whole. From the perspective of economic prosperity and growth, this is probably the single most beneficial effect of, and most important reason for, reducing the capital gains tax rate. The lower cost of capital would translate into a greater amount of capital and a higher capital-labor ratio, hence a higher level of labor productivity, a greater demand for labor services, and a larger number of jobs being created at higher rates of pay throughout the economy. In terms of increasing the tax base this is probably the most significant benefit that the government will realize from reducing the capital gains tax. Most of this new income will be taxed, not at the lower capital gains rate, but at the higher regular corporate and individual income tax rates.

It is likely that the combination of these effects will result, ultimately, in generating greater revenues for the government. If these greater revenues are applied to deficit reduction and are not simply used to expand the size of government, the revenue enhancing aspects of a capital gains tax reduction could contribute to the overall betterment of the economy.

Conclusions

The high and growing level of concern throughout the Nation about the adequacy of our national saving highlights President Bush's proposal to reduce the tax on capital gains. It is the significance of the proposed tax reduction for reducing the tax bias against private saving that gives urgency to the proposal and to similar proposals that have been made by various members of the Congress. Along with its implications for moderating existing tax distortions of market prices and alleviating the resulting resource misallocations, the capital gains tax reduction's potential for enhancing the Nation's saving and capital formation warrant assigning top priority to the proposal. Additional measures are also needed in pursuit of these basic economic objectives. The President's proposal, therefore, should be seen as an initial step. As such, it is all the more urgent that it be enacted.

Mr. MOODY. Thank you very much.

It's my pleasure, Mr. Chairman, to welcome to the committee my former professor, Joe Pechman.

Chairman ROSTENKOWSKI. He's been a professor to a lot of us.

STATEMENT OF JOSEPH A. PECHMAN, PH.D., SENIOR FELLOW EMERITUS, BROOKINGS INSTITUTION, AND PRESIDENT, AMERICAN ECONOMIC ASSOCIATION

Mr. PECHMAN. Thank you very much. It's always a pleasure to appear before the Ways and Means Committee, particularly when Jim Moody is in the chair.

I want to summarize my statement and refer to three aspects of the controversy over the capital gains proposal. One is the revenue effects; second is the distributional effects; and third the effects on the 1986 tax reform which I supported and still support as a major milestone in the history of taxation and which the capital gains proposal would undermine.

With respect to the revenue effects, it seems to me that it's clear from the analyses of private experts, CBO, and the Joint Taxation Committee, that the short run must be distinguished from the long-run.

In the short-run, a reduction in the capital gains tax will probably increase the incentive to realize gains from the pool of accrued gains that have been accumulated over the years. So you may get a surge of capital gains realizations which may reduce the revenue loss or keep the revenue the same or possibly increase it for a year or so. But, ultimately, that surge will peter out and in the long-run the permanent effect will be a reduction in the amount of tax realized from capital gains.

The Treasury estimates that there will be an increase in capital gains realizations over the first 5 years, which will be offset in the second 5 years. I calculated that this would require a total increase in realizations of capital gains of about $1.5 trillion over the next 10 years, which is an absurd assumption.

There's no evidence that the capital gains tax has a major permanent effect on the level of security prices as has been alleged by others. You increased the capital gains tax in 1986 from 20 to 28 percent and in the year after the act was passed, we had one of the biggest booms in the stock market that we've ever had. I don't know of anybody who attributes the stock market crash of October 19, 1987 to the tax reform bill. On the contrary. The tax reform bill, created a level playing field which has inured to the benefit of the entire economy since then.

Since the Tax Reform Act of 1986 was passed, the economy has done extremely well. As a matter of fact, we're now fighting inflation and overutilization of capacity. There's no evidence that the increase in the capital gains tax from 20 to 28 percent in 1986 had any major effect on the economy.

With respect to the distributional effects, you've heard the numbers. Some people emphasize the number of taxpayers who are likely to receive benefits from a capital gains reduction. Others emphasize the percentage of capital gains that is reported in the top income brackets. I agree with the latter.

There's no question that a capital gains tax cut would really benefit the rich. I calculate from 1985 statistics that the top 1.2 percent of returns with incomes above $100,000 accounted for about 60 percent of all long-term capital gains.

I also would like to illustrate to you the kind of tax cut that would be involved for the very wealthy which can be easily calculated from statistics of income. In 1985, the total amount of capital gains reported on individual income tax returns with adjusted gross income of $1 million or more was $36 billion. There were 14,000 returns in that class. That works out to an average capital gain of $2.5 million per return.

If you reduce the capital gains rate from 28 to 15 percent, that would be a 13-point reduction on $2.5 million, which my arithmetic tells me would amount to an average of $325,000 per return. In other words, the reduction from 28 to 15 would enrich the top bracket taxpayers by an average of $325,000.

Finally, I want to mention the point I made about the Tax Reform Act of 1986. The equalization of the capital gains rate and the ordinary income tax rate was the keystone of that act. If you restore a differential, that will generate all sorts of pressures to restore many of the loopholes in the old tax law. Because of the need for revenue, you're going to have to increase the tax rates on ordinary income to offset the revenue loss. Very quickly, it seems to me, you'll be back again to the very unsatisfactory condition that we were in prior to 1986 which led to the demand for tax reform that this committee responded to.

I think that it would be very unwise to unravel what was done in 1986. The economy has done well since tax reform. It should not be reversed unless there is inclusive evidence that a change is needed and, to my knowledge no such evidence exists.

Thank you very much.

Mr. MOODY [presiding]. Thank you very much.

[The statement of Mr. Pechman follows:]

A CAPITAL GAINS TAX CUT DOESN'T MAKE SENSE

Joseph A. Pechman

Statement before the House Ways & Means Committee
April 13, 1989

When President Bush unveiled his proposal to reduce the maximum capital gains tax rate to 15 percent on February 9, he argued that it will raise revenue, increase saving, stimulate venture capital investments, raise productivity growth, and improve U.S. competitiveness in world markets. None of these claims can be substantiated. Furthermore, a capital gains tax cut would be a bonanza for the rich and would undermine the tax reform achieved in 1986.

The controversy over the revenue effects of a capital gains tax cut cannot be understood without distinguishing short- from long-term consequences. A cut in the tax will certainly encourage some investors to cash in some of their accumulated capital gains, although this short-term effect has been exaggerated by proponents of the cut. But the initial surge in realizations cannot be repeated year after year because the pool of accumulated capital gains becomes depleted. Revenues might rise or fall only slightly in the first year or so, but then they would drop sharply as the volume of realizations settled down to a normal level. The Congressional Budget Office estimates that a 15 percent capital gains tax rate would reduce federal revenues by at least $4 billion a year. (The Treasury projects that revenues would increase by a total of $15 billion in the first four years and then decline by an equal amount in the following six years, but this assumes that realizations would increase by an average of $150 billion a year, or a total of $1.5 trillion, during the decade--an estimate that cannot be taken seriously).

Of course, some argue that the pool of accumulated gains will increase after the tax cut, but recent experience provides little evidence that the capital gains tax drives asset prices. On the contrary, the stock market remained virtually unchanged for almost two years after the capital gains tax rate was cut in 1978 and rose sharply in the year following the rate increase enacted in 1986. This is not to say that there is an inverse relationship between the capital gains tax and the level of the stock market, but the evidence of a positive relationship is weak.

Saving, investment, and productivity growth have also shown no relationship to the capital gains rate. During the 1978-86 period when the maximum capital gains rate was cut first from 35 to 28 percent and then to 20 percent, private saving declined to the lowest level since the end of World War II and productivity growth remained depressed. The alleged connection between capital gains taxes and venture capital is also suspect because a large share of such capital--as much as 50 percent according to the Treasury Department--comes from pension funds and other tax-exempt organizations. And, in light of the huge increase in the trade deficit in the early 1980s, U.S. competitiveness can hardly be said to have been improved by a low capital gains tax.

One thing that is clear is the high concentration of capital gains among the rich. In 1985, five out of six tax returns with an income above $1,000,000 reported capital gains, while fewer than one in twenty at the $10,000 level reported such gains. The 1.2 percent of returns with incomes above $100,000 accounted for about 60 percent of all long-term capital gains.

The top bracket tax rate on income other than capital gains has been reduced from 70 percent in 1980 to 50 percent in 1983-86 and 28 percent beginning in 1988. Only a small part of the revenue loss from these rate cuts was recovered by the 1986 increase in the capital gains rate from 20 to 28 percent. If the capital gains rate were reduced to 15 percent now, there would be a double benefit for the wealthy: a cut in the top bracket rate on ordinary income from 70 to 28 percent and a cut in the maximum capital gains rate from 28 percent to 15 percent. At the 1985 level of realizations, the capital gains tax cut alone would average about $6,500 for those with incomes of $100,000-$200,000, $20,000 for $200,000-$500,000 incomes, $55,000 for $500,000-$1,000,000 incomes and $325,000 for incomes of $1,000,000 or more.

One argument always advanced when capital gains taxes are discussed is that it is unfair to tax nominal capital gains during the period when the general price level is rising. The remedy for this problem is to adjust capital gains for inflation, not to reduce the rate for all gains held for more than a certain number of years. Clearly, the adjustment for a gain held for 10 years should be much larger than for a gain held for 3 years. Yet, the administration's proposal would treat them alike. Capital gains are already being adjusted for inflation in Australia, Canada, and the United Kingdom, and I believe that the United States should do the same. The revenue loss would be relatively modest in the initial years if the adjustment is made for inflation after the date of enactment of the legislation.

The keystone of the 1986 tax reform was the elimination of a tax rate differential between capital gains and ordinary income. While we have not quite achieved a "level playing field" for all businesses and investments, we have made a good deal of progress. Most tax shelters are no longer profitable and investment is now motivated largely by economic rather than by tax considerations. The proposed capital gains tax cut would once again encourage the conversion of ordinary income into capital gains and inevitably restore the economic distortions generated by the old tax law. Tax avoidance would again take its place as the national pastime.

The economy has done well since the enactment of the Tax Reform Act of 1986. The low tax rates in the United States are the envy of the entire world and other countries are rushing to follow suit. It would be tragic to waste revenues and to lose the benefits of tax reform in order to pursue will-of-the-wisp economic objectives.

Joseph A. Pechman is Senior Fellow Emeritus and formerly Director of Economic Studies at the Brookings Institution. This testimony is adapted from an article that appeared in The New York Times on February 8, 1989.

Mr. MOODY. Mr. Satagaj.

STATEMENT OF JOHN S. SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Congressman.

I appreciate the opportunity to testify today. Our principal message is a slightly different one. It's that the subject of capital gains is very much a small business issue.

Throughout the life cycle of a small firm, capital gains plays a vital role. While we recognize that there will be a debate over whom are the beneficiaries of the long-term capital gains exclusion, we urge the committee not to lose sight of the fact of the valuable contribution a capital gains differential has made to the vitality of the small business economy and job creation.

The role of capital gains is most obvious at the birth of a small business. In particular, it serves as a catalyst to investment by both the informal and formal venture capital communities. Venture capital, whether it is made by an informal or formal investor, is not offered without significant risk, nor is the return immediate. The capital gains differential enhanced the venture capitalist's ability to take the risk that has paid off as dividends in the form of jobs. We believe it to be a basic building block to innovation and job creation. It's as important as the entrepreneur with an idea and the faith of others to make it happen.

In any convocation of small business owners over the last 12 years that I've been involved with small business, capital gains remains one of our highest priorities and we urge, whatever this committee does, that you consider this aspect and the impact on small business.

Thank you very much.

Mr. MOODY. Thank you very much.

[The statement of Mr. Satagaj follows:]

STATEMENT OF JOHN S. SATAGAJ, PRESIDENT
SMALL BUSINESS LEGISLATIVE COUNCIL

On behalf of the Small Business Legislative Council (SBLC), I would like to thank the Chairman for the opportunity to testify on the subject of capital gains. As you know, the Small Business Legislative Council is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

Our interest in a capital gains rate differential is fundamental. It contributes to innovation, investment, job creation and small business growth. We believe that it can make a difference in the world marketplace. As you know, we are virtually the only major trading nation that taxes capital gains as ordinary income. We will not achieve a global level playing field without addressing the advantages enjoyed by our competitors as the result of the lower cost of capital in other countries.

Likewise, we cannot continue with the short-term mentality that exists in many board rooms today. The emphasis has shifted to the next quarter's report rather than on the long-term health of the company, industry and economy. Merger-mania has only aggravated this problem. We must refocus our attention toward the long-term investment climate for America. We believe restoration of a real long-term capital gains exclusion will send a message to the investment community that long-term planning, and long-term commitments are the only way that we will regain our competitive place in the global economy.

Our principal message today, however, is that capital gains is very much a small business issue. Throughout the life cycle of a small firm, capital gains can play a vital role. It also can contribute to business continuity and to the preservation of the family-owned enterprise. While we recognize that there will be a debate over whom are the beneficiaries of a long-term capital gains exclusion, we urge the committee not to lose sight of the valuable contribution a capital gains differential has made to the vitality of the small business economy and job creation.

The role of capital gains is most obvious at the birth of a small business. In particular, it serves as a catalyst to investment by both the informal and formal venture capital communities. It is the organized venture capital market that seeks out and encourages the innovative high growth firms that are the creators of jobs in our economy. Studies over the years have demonstrated a strong correlation.

The impact of venture capital can be measured in tax revenues, job creation, and development of new industries. Substantial tax revenues, in terms of both corporate and employee income taxes, are generated by new businesses in new industries. We recall a study conducted in 1982 by the U.S. General Accounting Office (GAO) of 72 venture capital-backed firms that illustrated the impact that the venture capital industry has had on the economy. The study reported that between 1970 and 1979, an estimated $350 million in tax revenue was generated from employees of venture-backed companies, and more than $100 million in corporate tax revenue was produced from the companies themselves. More importantly, an estimated 130,000 new jobs were created by these companies during this period. And it was done with an aggregate venture capital investment of only $209 million.

The GAO also projected that a $1.4 billion investment during the years 1970 to 1979 in 1,332 venture-backed companies could by 1989, create 1.9 million new jobs annually and produce $6.7 billion in annual tax revenues.

The development of venture capital-backed enterprises also contributes to the growth of the American service economy. Some time ago, _Time_ Magazine estimated that the less than 100,000 new high-tech jobs created in Fort Worth since 1979 "helped to create service opportunities for another 92,000 workers." David Birch of MIT concluded in a study that fast-growth companies, which represent just 7 percent of all businesses, create 67 percent of all new jobs.

Venture capital investment is not without significant risk, however, nor is the return on the investment immediate; the capital gains differential enhanced the venture capitalist's ability to take the risks that have paid dividends in the form of jobs to the economy.

Capital gains has its populist side as well. The government's 1987 State of Small Business Report noted that informal investors - friends, relatives and business associates - are the second most commonly used source of equity capital financing after internal financing. The report stated that "preliminary estimates indicate that total informal equity capital investment in small businesses amounted to approximately $300 billion in 1983." Altruism aside, the informal network does expect a return on its investment, and capital gains has been a part of that equation.

In the end, while capital gains suffers from associations with get-rich-quick schemes and unproductive assets with inflated values, we, in the small business sector, know it to be as basic a building block to innovation and job creation as the entrepreneur with an idea and the faith of others to make it happen.

We share the belief that lowering the rate will result in a net tax revenue gain. In any event, we hope the revenue debate will not overshadow the value of the differential.

We do believe that if an appropriate definition can be developed, a distinction between productive assets and items such as paintings, coins and rugs would address the concern that the capital gains differential is of value only to the wealthy. Likewise, an investment in a small business is not made for six months or a year, therefore we would support a longer holding period for such investments.

At SBLC's last internal issues conference, we said the following regarding capital gains:

> "(a) A federal capital gains tax provision restoring a meaningful differential must be enacted to assure adequate availability of equity capital for new and growing small businesses. A low capital gains rate with a significant differential is also needed to attract senior management talent for young, growing companies. The failure of the Tax Reform Act of 1986 not to retain a permanent, long-term capital gains differential has made it extremely difficult for independent companies to obtain much needed growth capital and award risk-taking managers as it highly favors listed, dividend bearing securities of larger businesses.
>
> "(b) There should be enacted a provision permitting the deferral of a capital gains tax liability provided that proceeds from the sale of a capital asset are reinvested in a qualified small business concern. A 'rollover' provision would serve as an incentive to invest in a long-term, illiquid and higher risk, but nevertheless innovative, job-producing company that now finds it very difficult to tap the equity markets. The proposal is analogous to the tax treatment afforded homeowners on the sale of a residence. SBLC supports the concept of a capital gains tax deferral on reinvestment in small business and urges Congress to pass legislation amending the Tax Code to create this incentive for investment in small firms."

As you may know, a capital gains rate differential was also a priority recommendation of the 1,800 delegates to the 1986 White House Conference on Small Business. Recommendation 12 called for the following legislative action:

> A federal capital gains tax should be enacted which will provide savers and investors in an operating business with:
>
> a. Deferral of tax on gain if proceeds are reinvested in a qualified operating business or an IRA account within 18 months.
>
> b. A normal capital gains tax rate of 75 percent of the regular income tax rate for the gain if assets are held for two years.

c. A special capital gains tax rate of 50 percent of the regular income tax rate if assets are held for five years.

d. An entrepreneurial capital gains tax rate available only to a former or present founder of full-time manager/owner who has held the investment for at least 15 years with a step-rated favorable capital gains rate.

We hope this Committee will look favorably upon the reinstitution of a capital gains rate differential. Thank you.

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American Dental Trade Association
American Floorcovering Association
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Fence Industry Association
International Franchise Association
Latin American Manufacturers Association
Machinery Dealers National Association
Manufacturers Agents National Association
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
NMTBA-The Association for Manufacturing Technology
National Asphalt Pavement Association
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Manufacturing Opticians
National Association of Passenger Vessel Owners
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors®
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Campground Owners Association
National Candy Wholesalers Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Independent Dairy-Foods Association
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
SMC/Pennsylvania Small Business
Small Business Council of America, Inc.
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

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Mr. Moody. Mr. Chairman.

Chairman Rostenkowski. You know, I can only reflect on what the panelists have said. There's always the temptation when you're looking for revenues, and that's the problem here. We don't sit around on this committee with my colleagues and talk about how we're going to do something specifically technical about what the code provides for. You all remember in 1986, we really became tax experts and it was because we had the pages in the newspapers about how to avoid paying taxes.

Joe, I couldn't agree with you or Doctor Ture more.

We start down this road and, boy, when do you put the finger in the dike? It begins with capital gains and then it goes to passive losses. I'm not criticizing anybody, but everybody feels that their situation is different than anyone else's.

Our problem here is that we've got a President that's going to veto anything that doesn't look like a duck. We've got a budget commitment that we're going to try to meet and we're looking at where we get the revenues. You start talking about loophole closures. Well, if you're going to talk about loophole closures, or at least the numbers that we've been talking about with this administration, it's been no more than $500 million. Well, that's not even worth convening the committee for, if we're going to be serious about deficit reduction.

So, we sit here and with your help we try to rationalize what is the direction that we can take. We've got a President that will use his pen as opposed to worrying about reading lips. That's the dilemma of this committee.

You know, we've looked at the surveys in capital gains more than anything else, and I know with Mr. O'Brien down there how long we've been on each other's adversary lists with respect to capital gains. If, in the long run, you're going to lose money but you want to generate money in the short run, what do you do? Is it something that a President could view as the possibility of signing?

It's a dilemma that we have. You know, I sat here with a conservative like Ronald Reagan and he and I were the greatest allies in the world and we've done something that people in this room would have called a miracle. Accomplished in 1986, but in 1984 they said it can't be done. So, we've done it.

I sit in a dilemma trying to figure out how do we get by the short run so that we can keep campaign commitments going to start doing something that's going to be effective on a bipartisan basis?

I enjoyed so much—and I think my colleagues could agree with me. When we were writing the Reform Act of 1986, I felt like we were doing something that was worthwhile and that all the people were going to benefit by. Now, here we are, we're back to revenue raisers.

It's sad because we're facing a crisis that we're going to have to do something about and getting from here to there which is going to make a lot of people on this committee very unhappy and disappointed and frustrated. But we're going to get an order by the end of next week from the Budget Committee and they're going to tell us, "Here's the revenue plug. Now you get it." I've got to sit in this room with 35 other members and try to figure out how do we get it.

I appreciate the fact that you shared your views with us. I just hate to think that we're going to do anything with respect to the achievement that we made in leveling that playing field. I know that there are certain different views about what capital gains and the lowering the rates mean. I hate like heck to think that it just means revenue to me but that's just exactly what it's starting to look like to me.

Joe, I'm sorry. I didn't mean to filibuster you four fellows.

Mr. PECHMAN. I couldn't agree more with what you said.

I want to add a couple points. One is, I'm afraid that President Bush does not agree with his predecessor on tax reform and tax policy. His first proposals on taxation would undercut the 1986 act, and I see no reason, as I said, why we should be in a hurry to unravel what we did. After all, despite the fact that the alleged cost of capital is so high, many other countries are rushing to do what the United States did in reducing the top marginal rates.

Furthermore, while most countries still do not tax capital gains or don't tax them in full, some have already taken that step. Australia, for example, taxes real capital gains. The United Kingdom also taxes real capital gains—but with a generous exemption—and Canada taxes 75 percent of capital gains. So, among the Anglo-Saxon countries, there's a distinct trend in the direction of including capital gains in the tax base.

With respect to revenue potential, I know that nobody wants to raise income tax rates and before raising the rates, I would certainly continue to eliminate as many unnecessary deductions and exclusions. The deduction for State and local tax is not a loophole. But the question is do we want to raise revenue by eliminating it rather than increasing tax rates. It seems to me there are many unnecessary deductions and exclusions in the tax law which could raise significant amounts of revenue. Not balance the budget, but raise significant amounts of revenue.

After you've done that and after you've modernized the excise tax system, I should add, it would not be a terrible thing to use the income tax to raise some revenue. Suppose you raised all of the tax rates in the individual income tax rates by one point, the 15 to 16, the 28 to 29 and the 34 to 35. Five years from now you would raise $33 billion for that one point.

Chairman ROSTENKOWSKI. But Joe, the problem is we need money now. You can talk about a value added tax. You can talk about anything that's a way to raise money prospectively, but this budget cycle says we've got to do so much now.

Mr. PECHMAN. One point would raise $25 billion now. It is a fantastic revenue raiser because you have broadened the tax base so much. A few years ago, many of us were opposed to using income taxation because by increasing the tax rates we would be increasing the taxes of people who already pay taxes and letting those who don't pay taxes go scott free. To a large extent, that's no longer true. Rather than resorting to a new tax like the value added tax, which is regressive, it is relatively simple and certainly will not hurt economic incentives if we use the income tax by raising rates moderately.

Mr. TURE. I think what you've done very elegantly, Mr. Chairman, is to point out to us that the people who work in the public policy area are always confronted with conflicting priorities. You have my heartfelt sympathy, you and your colleagues.

I would suggest that putting revenue adequacy, whatever the word adequacy means in this context, as a top priority would be a gross mistake. I know that your committee, and subsequently the Finance Committee, are not going to have much choice because somebody else is going to tell you you've got to do it. I think that is an enormously regrettable situation. I've offered at one time or another, as you know, some suggestions to the effect that we ought to try to think about reversing the sequence. But that's not even academic at this point.

Nevertheless, I would very strongly argue that there are two sets of considerations that ought to come at least on the same level as revenue and I would put them way ahead. One is I think you have an enormous responsibility, very difficult to discharge, to look at the structure of the tax law and against appropriate criteria say, "Is it right? Is it deficient? What do we need to make it conform more closely with the appropriate criteria?"

For me, and as I've represented to this committee many times in the past, the single most important criterion is is the tax system as nearly neutral as it possibly can be?

I think there was a lot to be said for what was done in the 1986 act. But there were a lot of places where it moved, in my judgment, away from neutrality rather than closer to. An awful lot of emphasis was given to moving in the direction of leveling the playing field. But in one respect we didn't level the playing field at all, we tilted it. We tilted it more against saving and in favor of consumption and more against certain kinds of capital and certain kinds of saving than against others. I think it is time to try to move to redress that, to move toward greater neutrality.

The second criterion that I think should be given very close attention is what is the overall impact of the kind of tax system we have on economic activity. Not just its levels, but its composition. It seems to me that we ought to be looking at the amount of saving that's going on here and the amount of capital formation that is domestically financed and we have to be very much concerned with whether or not we cannot do something constructive to reduce the tax bias against saving and therefore elicit a higher volume of domestic saving.

Someplace in there you have to be concerned about revenues. There's no question about that. It would be utterly unrealistic to say you should ignore that. But it seems to me those revenue concerns have to take into account these other two sets of criteria.

Mr. Pechman has just suggested that single point additional tax rates will raise you a whole bunch of money. Well, if he's concerned about maintaining the sanctity of the 1986 act, you ought to maintain it with respect to the rate structure as well as with respect to its structural provisions.

I am perfectly prepared to say we ought not to regard the 1986 act as the ultimate piece of tax legislation and there are lots of changes that should be made and made quite promptly. I would strongly urge the last thing in the world you would want to do would be to increase tax rates at this juncture.

Mr. Moody. Thank you. The other gentleman, Mr. O'Brien.

Mr. O'Brien. Just an observation, Mr. Moody and Mr. Chairman.

It seems to me that there are a couple of reasons why I still feel capital gains tax reductions make sense, as I have felt that for 12 or 14 years. As the Chairman said, we have been adversaries from time to time on the subject. Not all the time and not completely. But I am persuaded, as I was in 1977 with the process which led up to 1978, that we are still not as competitive in the worldwide stage as we should. That bothers me. Forget about the securities industry.

I think, therefore, we also have to recognize the fact that the savings rate in the United States is really at a paltry level. I believe that this can contribute to the alleviation of that problem. If not completely, of course, it will not, but at least it can have an effect.

I also believe that it will produce revenues. Then I would take you back to 1977 and the Tax Act of 1978 when the rates came down. The future was unclear in those days to the Members of the Congress and the members of this committee. There were all sorts of questions, will it work, will it not work. I remember distinctly being asked the question, both on the Senate side and here, will it work and can you prove it? My answer was, "Yes, it will work. I can't prove it yet, but it will be demonstrable over a period of time."

The record now shows that what was an act of faith by the Congress in that time, and that's what it was, turned out to be the right thing to do. The record seems to support that all those years down to the point where we are here in 1989. So those observations, to me, are quite persuasive.

Mr. Moody. Thank you very much.

Let me just quickly ask Joe Pechman a question.

Looking at your paper, you use these distributional figures. When you say low-income people below $10,000, is that their AGI? Because if so, that might include wealthy people—if you're using other than very recent numbers—who were able to zero out their AGI through tax shelters.

Mr. Pechman. Sure, they do include the people with low-adjusted gross incomes because they had tax shelters and deductions that exceeded their other income. That makes the distributional effect of a capital gains tax cut even less pronounced than it is. I take it that's what you're trying to say.

Mr. Moody. Yes.

Mr. Pechman. That is the distributional effect from the income tax returns understates the unequal maldistribution of the gain that would occur in the higher income brackets as a result of capital gains cuts. You're entirely right.

Mr. Moody. My other question is, when you look at the rest of your analysis, you take these snapshot figures, people who have, let's say, over $100,000 a year. Now, they might have $100,000 because they had a big capital gain. In other words, their permanent income might not be $100,000. Or are you looking at multiyear?

Mr. Pechman. No; I can't get permanent income from income tax returns. These are annual incomes.

Mr. Moody. So, it does skew it up a little bit.

Mr. PECHMAN. It does skew it a little bit. But if you look at statistics of income annually, you will find that the ratio of capital gains to income rises sharply as AGI rises, every year.

Mr. MOODY. Even on a longitudinal sense, not just cross sectional?

Mr. PECHMAN. Oh, yes.

Mr. MOODY. Because you can see how that cross section would be skewed.

Mr. PECHMAN. The longitudinal would be less unequal, but it still would be quite unequal.

Could I add one point about the saving?

Mr. MOODY. Sure.

Mr. PECHMAN. The argument that we need additional saving is, of course, correct. One major reason why we have such a low saving rate is that the Federal Government is dissaving to the tune of about $150 billion a year. The best way economists know how to increase the saving rate is simply to eliminate the Federal deficit.

Now, if you reduce the capital gains rate, as I indicated, I think in the long run you're going to reduce revenues and, therefore, reduce saving. But even taking the effect on private saving alone, there is no basis for expecting an increase in saving. Between 1978 and 1986, the capital gains rate was reduced from 35 percent to 20 percent and despite large reductions in marginal tax rates and large increases in interest rates—the saving rate declined. The capital gains rate reduction was associated with a decline in saving.

Now, I'm not arguing that the capital gains reduction caused the reduction in saving. What I am saying is that the statement that a capital gains tax cut will increase saving cannot be backed up by the available evidence.

Mr. TURE. The kind of evidence that you've cited, Joe, is not relevant evidence. Year over year changes in any variable related to year over year changes to any other do not tell you anything at all. They have no analytical content whatever.

Mr. PECHMAN. That's exactly what I said. I said that we don't know what the effect is. So, why do you say it's going to——

Mr. TURE. By the same token, you're saying that we don't have a leg to stand on because the year-over-year changes don't validate the assertion is an empty statement. Nobody should, nobody at this table and nobody up there, should look at the year-over-year changes to establish the verity or the lack of verity of any of these propositions.

Mr. PECHMAN. Would you mind telling me what I should look at?

Mr. TURE. You have to look at something that is very difficult to come by indeed.

Mr. PECHMAN. You can't find it.

Mr. TURE. Excuse me, Joe, let me finish.

Mr. MOODY. One at a time, please.

Mr. TURE. Perhaps you can and perhaps you cannot, but what you have to do in order to examine the effect of a change in any provision in the tax law is to determine what the result would be absent that change. To be sure, that is difficult. But that is the only thing that's going to tell you whether or not changing the capital gains tax rate or changing any other provision in the code will have an effect on saving, what happened to saving this year as opposed to last.

Mr. MOODY. We'll all agree that you can't argue post hoc ergo procter hoc. We all agree on that. But I guess if I can translate or maybe be a neutral broker here, I think what maybe Joe Pechman is trying to say is whatever force was there was not strong enough to manifest itself. A lot of us know the direction of the force. We wouldn't disagree. The question is, is it a trivial inertia impact here or is it the size of the magnitude? I think theory tells us the direction, but where is the strength of the force? That's very difficult to sort out.

But if it was very strong, if I understand Mr. Pechman, we would have picked it up in this longitudinal data. If it's not so strong, it would be swamped by other things. Is that a fair summary?

Mr. PECHMAN. I think it's a fair statement.

Mr. MOODY. Mr. Ture.

Mr. TURE. I've offered the observation in many forums, I think perhaps in this one as well on several occasions, that it is a gross mistake for all of us who are involved in the public economic policy area to attribute much more strength and influence to public policy changes than they warrant.

We live in an enormously dynamic and complex economic environment. I think the best you can say about any public policy variable is that its change exerts an influence. It's wrong, it seems to me, to perceive the U.S. economy, this massive set of operations, as a marionette dangling at the end of public policy strings. I think we ought to try to pull those strings in the right way to try to exert the right kind of influence, but we ought not to go weeping into a corner if we don't find that influence is strong. We ought to try to do the right thing in any event, even if the results do not match our expectations.

Mr. MOODY. But that gets us back to the point of the revenue solvency restraint we've got up here. We've got to meet revenue targets, so we can't necessarily do what might be right.

Let me put it a different way. If you are at risk adverse and you realize there's great uncertainty and yet you've got a budget restraint or a deficit restraint, and when you see the swings of magnitude between the Treasury estimations and the Joint Tax Committee and the $30 billion swing range of estimation and being risk adverse on the deficit problem, we don't want to see the deficit balloon suddenly larger than we expected.

It seems to me that as you minimize the maximum bad thing that can happen, and a minimax strategy would indicate that you go cautiously on cutting capital gains rates. Would you—Mr. O'Brien and Mr.——

Mr. O'BRIEN. All I would say, Mr. Moody, is that with all of the talk about the revenue estimates and this and that, it fails to take into consideration human nature and that's something that the Congress has the privilege and, in fact, the obligation to do. They did that in 1978 and it worked and I suspect that if they do it again, they will unleash a new culture which will produce the better results than we're now achieving.

Will it absolutely put us into the forefront of the world as being the top saving nation? I doubt it because I would agree with those who say that there are many other factors. But to say that nothing will happen justifies common sense. If nothing else, the Congress deals with common sense.

Mr. **Moody**. Right. Well, it's not to say nothing would happen. But is this the most cost effective way of spending the money, assuming there is a revenue loss, to achieve greater competitiveness? Let's say greater international competitiveness is our goal. Should we put it in education, manpower training, R&D or should we put it in cutting capital gains? I mean if that's your target, then you have to ask yourself a cost effectiveness question, do you not?

Mr. **Ture**. But notice, Mr. Moody, you've assumed that this is a revenue looser.

Mr. **Moody**. Well, I'm saying if you were risk adverse and have to assume there might be revenue loss because we can't afford a big revenue loss, so we're going to have to be very, very careful on the down side.

Mr. **Ture**. Let me repeat the statement I made in response to the chairman's observations. I think you indeed have to be very much concerned about what the revenue consequences will be. I wouldn't give that top priority.

It seems to me the first thing that you ought to do, however, is to ask my former colleagues in the Treasury and my friends here to go back to the drawing board on those revenue estimates. As I've seen both sets of estimates, they have focused on one of the many possible effects of a change in the tax treatment of capital gains. That is the transaction effect. To put all of your revenue eggs in that one basket seems to me to be a gross error.

Mr. **Moody**. But you did see that point that Joe Pechman made, that it would assume $1½ trillion worth of transaction which I take it is a magnitude, a quantum leap from what we would otherwise be expecting. Now, would that kind of impact be likely volume-wise?

Joe.

Mr. **Pechman**. Well, I just want to defend my former colleagues in the Treasury. Norman was in the Treasury too. We used to make revenue estimates. They're very difficult.

The fact of the matter is that there are 10 different estimates to make up the total estimate that the Treasury provided. Many of the effects are negative. One of them, for example, is the effect on the conversion of capital gains into ordinary income that this reduction would promote.

So, they tried. They tried the best they could to take into account as many of the factors that they could quantify.

What is wrong about their estimate is this $1½ trillion of increased realizations, or $150 billion a year, that they assume will occur as a result of the capital gains tax cut. I find that incredible.

Mr. **Moody**. Let me ask my colleagues to join in. Mr. Dorgan, go ahead.

Mr. **Dorgan**. Thank you very much, Mr. Chairman.

Mr. Ture, let me ask a question. On page one you have a title, "The Income Tax Bias Against Savings and Investment." All of us are concerned about trying to increase the savings rate in this country. Clearly that makes sense. Yet, I know that those who say that if we can impose new capital gains tax preferences that will increase the savings rate et cetera.

Last evening in my mailbox, I got two solicitations for credit cards. One of them was platinum and the other was some other extraordinary new level card. The night before, my wife got a letter saying that she had been preapproved for a $2,500 loan from this bank and if she would just sign this, she'd get the $2,500. There's no application involved, she was just preapproved. No nothing. She just got this thing in the mail. My daughter, a freshman in college, told me last week that she wanted to know which credit card she should take because she had gotten two different solicitations from two different companies that were—I think, Mastercard or Visa. I think it was probably Visa. She doesn't have a job.

Now, the question is, let's assume that we do these things in capital gains, do all sorts of things and accept your notion that some ought to be good for the country, we'd raise additional revenue, not cost us revenue. Isn't that kind of spitting in the wind of the whole approach here in this country? Do you ever hear anybody talk about saving anymore to do anything? The whole notion is to spend and consume now. Don't defer consumption. You walk down the street, a block from this building, and the picture window of the store is going to say to you, "Norman, come over here. I've got a deal for you. You buy what's in this window, you take it home today, you don't make a payment for 6 months, you get a rebate next week." That's the whole mentality of this country. The whole mentality of the private sector, those that are financing activities is to say—and the public sector. But the public sector mentality is not enhanced but impeded. I think, by recommendations that we ought to do something that would increase the debt.

But notwithstanding that, I'm just wondering how you suggest in order to try and improve the savings rate in this country we turn a corner someplace and suggest that this kind of behavior, the kind I've just described to you, is out of sync with the basic notion that you and I share, that we should increase our savings rate.

Mr. TURE. Let me give you a little anecdote too. I was a very young fellow at the time, but I do remember still, very clearly, back in the early thirties, seeing a huge billboard in my hometown that said, "President Roosevelt wants you to spend now." Well, under the circumstances, there weren't too many of us who were able to heed that injunction.

I think you have put your finger on something that is quite consequential. Not because we have increased the efficiency of the use of credit instruments for financing purchases, but because we have spent a great many years emphasizing the importance of consumption as the vehicle for keeping the economy fully occupied and fully employed and have ignored, until quite recently, the importance of saving and capital formation for purposes of expanding and raising the growth path of the economy.

I think there is an awful lot that could be done by way of education in the universities and in the public policy forums to try to restore the emphasis on saving rather than merely on consumption. In my judgment, the best way to proceed from your point of view in terms of what you can do is to move toward providing a tax structure that is more nearly neutral than the present one in its impact on saving and consumption choices. If you were to move in that direction and were to tell the body politic you were doing so and why, I think that would be a wholesome influence.

Mr. **Dorgan**. Let me follow with one other question. I appreciate that observation. Maybe Dr. Pechman and others have some observations in that general area.

Mr. **Pechman**. Yes, I do.

Mr. **Dorgan**. You do?

Mr. **Pechman**. Yes.

Mr. **Dorgan**. Go right ahead.

Mr. **Pechman**. Neutrality between saving and consumption, in Mr. Ture's terms, means that he doesn't like an income tax. What he's telling you is that we should scuttle the income tax and substitute an expenditure tax. Norman Ture has been in favor of any provision that reduces the tax on capital because he doesn't want to tax capital income.

Now, that argument was discussed at length by this committee. It has been discussed all over the world. Every country of the world has rejected the notion of substituting an expenditure tax for an income tax. So, under the circumstances, if we're going to keep the income tax, the thing to do is to tax all income alike and keep the tax rates as modest as possible.

I suggest to you that the Tax Reform Act of 1986 conforms with that requirement exactly. We expanded the tax base and reduced the number of loopholes. Now we have the lowest tax rates in the world, which is the envy of other countries and they're trying to follow us.

Mr. **Dorgan**. Thank you very much.

Dr. Ture.

Mr. **Ture**. Let me restate for the committee what my concept of neutrality is and what it is that I want to see.

The concept of neutrality that I think is appropriate is that the tax or tax features should, to the least extent possible, distort the relative prices that would prevail in the absence of taxes. I think that our present tax structure has the unfortunate effect of raising the cost of saving relative to the cost of consumption. There are a large number of measures that can be taken within the context of the income tax structure to reduce that bias against saving.

I have urged repeatedly before this committee, I think going back to the late sixties, certainly to 1973, that that should be the principal guiding set of principles for the committee in its deliberations on taxes.

I do not favor, as I have said to this committee and others, a value added tax. I would favor moving our income tax toward a consumption base and I would call to your attention to Blueprints for Basic Tax Reform produced by the Treasury staff and published in January 1977 which laid out two blueprints for alternative ways to go toward alternative tax systems. One of them was a consumption based income tax. I think there is much to be said in its favor.

Mr. **Dorgan**. I remember reading David Stockman's book. He left Government and wrote a book, which is not too uncommon these days. In his book, he indicated that a lot of things went haywire in the 1980's.

One of the things that went haywire, according to David Stockman's book was that there were a group of disciplines who believed, I think, in the Laffer approach that if you just continue to reduce rates you would yield extraordinary benefits from that, and a reduction in income tax rates in itself would unleash a slothful, indolent people who weren't working very hard because rates were too high, unleash them to new heights of productivity. His point was that we kind of missed that. A lot of other things happened, but we also missed that.

So, in the early part of the 1980's, there were a group of people suggesting to us that if we did a certain thing we'd have these enormous rewards. That's kind of what we hear today with respect to capital gains. My question is, what if you're wrong? What if Treasury is right? What if you're wrong and congressional budget is right and this costs us $24 billion in 5 years? What if that's the case? Isn't that a substantial risk in a country in which our fiscal policy is already so far off track and it would command our efforts in most cases to spend full-time figuring out how to put it back on track?

What if you're wrong?

Mr. Moody. Will the gentleman yield?

Mr. Dorgan. I yield.

Mr. Moody. Put in your answer, if you would, Doctor Ture, the effect on the monetary side. If this happens—that's what I meant by risk adverse. If that happens and we drive up interest rates a couple hundred basis points by virtue of a bulge in the deficit unexpected, then you might have more adverse effect on savings than anything we might have done as a fiscal policy.

Mr. Ture. Well, let me respond to that first. I've never been able to find any kind of reliable connection between either the level, the direction of change or the rate of the direction of change of the deficit and interest rates. That would not be my concern, Mr. Moody.

Mr. Moody. Are you saying there is no connection between deficit and——

Mr. Ture. I've not been able to find it and I think most researchers have a terribly difficult time trying to find anything.

Mr. Moody. But this is just like the argument you and Joe Pechman had about the effect of capital gains on—because so many other things are drowning it out, it doesn't mean it's not there or that you don't even believe in it. You do believe that higher interest rates, I assume, reduce after tax returns to capital?

Mr. Ture. You now have several points on the table. One of them is whether or not there is a connection between the deficit and interest rates. My answer is that neither on abstract or empirical grounds do I believe there is any such connection. There are other reasons that I——

Mr. Moody. Has this been a consistent view of yours over the last couple of decades——

Mr. Ture. Oh, yes.

Mr. Moody [continuing]. Or is this just a recent observation based on recent history? You've taught economics, I assume. I think all of us here have probably taught economics. There has normally been presumed to have been a connection between the kind of Federal deficit we would have had in recent years and interest rates. But you have traditionally felt that's not the case?

Mr. **Ture**. I think the first time that I went public or had any occasion to go public on this subject was back in the mid-1970's and I issued a memorandum to a number of my then consulting clients that said, in effect, if—by virtue of the very large deficits we were then facing—the Fed were to do what it has done in the past, that is to monetize those deficits, the inflationary consequences of that action would certainly have an adverse effect in raising interest rates.

Certainly you can look at what's happened to the explosion of deficits in the 1980's and their subsequent gradual decline and you can't find any connection between those deficit movements and what the Fed has done. I can say, on behalf of the Fed, that I think they deserve a great deal of credit for having resisted what many of their predecessors had not resisted and that is the inclination to monetize debt. But it seems to me that's where the connection is.

Let me come back, however, to your basic question which is sort of what's the down side on this. I guess it was before you came into the chamber, Mr. Dorgan, I had observed that the committee has a problem, as all public policy formulators do, trying to assign priorities. I would not assign the top priority to the revenue effects of this change. I would rather be more concerned about the rightness of it against basic tax policy criteria and in terms of its economic effects.

You preface this by citing what Mr. Stockman said in his book, and I would assure you that certainly nobody in the Treasury when I was there believed in the Laffer curve. I would also point out, neither did Mr. Stockman, because if you go back to our 1981 white paper in which we projected what we thought would be the consequences of the Reagan fiscal policy program, we showed a very substantial reduction in revenues, not an increase. There was no Laffer curve effect there.

This is quite a different question. You are looking at specific responses to a specific proposed change in the tax law. A transaction response, a valuation response and a response with respect to the levels and character of economic activity. I cannot sit here and tell you that for certain the effect of the proposed reduction in capital gains is that you will have more revenue than you otherwise would have. But it strikes me as highly probable that you will.

Mr. **Dorgan**. If I might ask just one additional question of the panel. In the old days, the capital gains preference allowed you to buy a piece of pottery that was 600 years old and hold it for 6 months and a day and you were able to pay substantially decreased tax on that, vis-a-vis somebody who went out and worked hard all day, sweating in the sun and carrying dirt or doing whatever they were doing. Or you could buy a painting on the wall that was 100 years old and sell it 6 months and a day later and pay a lower income tax.

Dr. Pechman's point, an appropriate point, I think, is maybe people ought to pay similar taxes on similar incomes in many instances. If you did go to a new capital gains preference, do you think at least it ought to be targeted? If you start down that notion that it ought to be targeted somehow, do you have a good idea of how narrow you would target that capital gains preference?

Mr. O'Brien, do you have any observations about that?

Mr. O'Brien. I think work has to be done on the subject. I concentrate my comments on areas where I think I have some credentials. I'm talking about the raising of capital for corporations and that type of thing. I think that that makes sense and I think that if you compare this country with the other countries around the world where the rates—and I disagree with Dr. Pechman on this—when he says that we have a change on the way, maybe it's on the way, but I haven't seen it. The record shows that the rates are right now. The fact is that they have lower rates and they save more money than we do.

I think apart from the revenue question, the real issue is whether you want to engender in a capitalistic country, which is what we purport to be, a system which is going to encourage people to accumulate capital and to save. I think this is a way to do it. Is it a miracle worker? Hardly. And unlike most of the other gentlemen here, I am not an economist, but my experience is as an investor and in that business for 35 years.

I think the Congress was right in 1978. They didn't know precisely what was going to happen, but they did it and it worked and the record demonstrates it. The reason is they place some faith in the people and the country to act. So that's my reaction to it.

Mr. Moody. Well, we certainly appreciate the depth of the discussion. It's been more of a seminar than a testimony.

Let me just conclude with a comment I heard from a wag the other day who said, "As we proceed through time, the two prototype systems, the Soviet Union and the United States, there's no labor in the system that's supposed to be based on labor and there no longer seems to be any capital in the system that's based on capital." Thank you very much.

[Whereupon, at 1:38 p.m., the hearings were adjourned.]

[Submissions for the record follow:]

STATEMENT OF ERICH BLOCH, DIRECTOR, NATIONAL SCIENCE FOUNDATION

The National Science Foundation wishes to place on record our support for the general outlines of H.R. 1416, a bill introduced by Mr. Jenkins with numerous cosponsors. That bill would make permanent the credit for research and experimental expenses, which we believe to be a primary instrument of effective national science and technology policy for a competitive world. Moreover, it would so markedly improve the structure of the credit as to increase its effective incentive to extra R&D by several times.

Improved structure

When the R&D credit was initially enacted, Congress set out to limit the associated revenue loss by making the credit "incremental" -- allowing credit only for R&D that exceeds an established base. That way the rate of credit on the incremental R&D could be set much higher than would have been possible, given revenue constraints, had the credit applied to all R&D. Congress reasoned that the historical level of R&D recorded in the base would have been maintained anyway without any extra incentive. Its goal was to provide a larger incentive for companies to do more R&D.

That reasoning was and remains sound. Unfortunately, in defining the base for the current credit a perverse counterincentive was inadvertently created. Extra R&D undertaken this year allows a company to claim credit this year, but it also increases the company's base over the next three years and so reduces the credit the company can claim in those years. The net result is that real incentive for the company to invest in extra R&D is cut to a fraction of the nominal credit rate.

H.R. 1416 would redefine the base to realize the original intent. A fixed base for each company would be increased by the percentage that gross national product has increased since the base years. Thus each year's credit would be unaffected by the company's R&D decisions and expenditures in other years, and the unintended counterincentive would be eliminated. A company with R&D above the GNP-indexed base level would therefore truly get an incentive to increase its R&D that corresponds with the nominal rate of the credit. Attached to my statement is an example that illustrates the difference.

This is the big improvement that H.R. 1416 and similar indexed-based credit proposals would make over current law. But there are others. The redefined base would allow credit only for real growth in R&D spending, not growth that merely reflects inflation. And an alternative reduced credit on a lower base would permit more firms to qualify for some extra incentive to increase R&D. Finally, a new firm or an established firm entering a new market would for the first time be eligible for the credit. Major innovations often arise from small startup firms or new lines of business.

The Treasury Department has estimated that if a fixed-base credit were modified to maintain strict revenue neutrality, the average incentive effect on a "marginal" dollar of R&D expenditure would still be five times that of current law. This corresponds very closely with estimates made at our request in 1985. Examining only the proposed shift from the current "rolling base" to an "indexed base", economists funded by NSF estimated a fourfold improvement in the incentive effect. Further structural improvements in the Jenkins proposal would likely raise this estimated improvement to about the same five-fold increase that Treasury's experts anticipate.

No one knows for sure how much a fivefold increase in incentive effect would increase the extra R&D the credit induces. However, the doubling or tripling predicted by several experts seems reasonable to us. I know of no offsetting cost to the public interest, nor any dissent among economists and tax experts who have studied the R&D credit from a now mature consensus that a credit restructured in this way would represent a major improvement over current law.

Value of a permanent credit

The greatly improved structure and incentive effect of the credit under H.R. 1416 redoubles our enthusiasm and reinvigorates the rationale for an R&D tax credit. Such a credit is one of the basic instruments of a sound national science and technology policy.

Individual private firms, and therefore the private economy generally, tend to significantly underinvest in R&D. When a firm invests in new plant or equipment, normally it alone among producers reaps the economic benefit from that investment. But not so with R&D. Knowledge does not stay put. When a firm invests in R&D, therefore, it can seldom keep the results to itself for more than a limited period. In some cases it may not even try to keep them to itself. So the benefits of the R&D investment are shared with other producers.

Moreover, a firm normally has a fairly secure expectation of how new plant or equipment will be used and will benefit the firm's business. A firm that invests in research, however, cannot be sure what, if anything, will be learned; how, if at all, what is learned can be applied; or who, if anyone, will benefit from the applications. The firm does have some notion of potential benefit, of course, and the narrower the scope of the research, the narrower the uncertainty. But always there are surprises, and often major ones. This unpredictability of results and benefits and the resulting risks are another reason why individual firms tend to underinvest in research.

For these and related reasons it is now widely accepted that Government should act to increase investment in R&D. One way in which we do that is through direct Government funding of research, such as is provided by the National Science Foundation. This has numerous advantages, particularly with more basic research, of which industry does very little. But it also has some disadvantages, particularly with more applied research and with development.

Government officials are removed from and inexperienced with marketing and production in particular markets and industries. They are also removed from the incentives and discipline of the market, and so may undertake or persist with lines of development that those subject to a stricter economic discipline would have eschewed or abandoned. This is where the R&D credit comes in. It reduces the cost of R&D and so helps to redress underinvestment in R&D. Yet it leaves industry and the market to determine, without Government, what R&D will be pursued.

If our nation is to regain its competitive leadership, we cannot continue trailing our chief competitors in commercial investment and commercial R&D, as we have been doing. The US has not kept up in commercial R&D with those who are pressing us for world economic leadership. (See attached chart.) An effective R&D credit will help correct that dangerous state of affairs.

I fully recognize, as must all who are involved these days with Federal budget-making, that budget stringencies force hard choices. But for me this particular choice is obvious. The major vice of Federal deficits is that they cut into productive investment in our economy, of which investment in R&D is particularly crucial. To cut back or eliminate the R&D tax credit would exacerbate the investment and R&D shortfall, not help solve it. The right thing for the country is to make this credit permanent.

R&E CREDIT BASE REDEFINITION
ILLUSTRATIVE EXAMPLE

A U.S. company has steadily growing R&D expenditures. Its R&D for the current year would exceed its base under either the current credit structure or the proposed modified structure. The company's VP for R&D now proposes to its CEO an extra research project that will cost $12 million in the current year, but will require no expenditures in later years.

Congress originally intended that the real cost of such an extra R&D project should be cut by the rate of the credit. As illustrated in the table below, in the first year that happens under either structure. But under the current structure the extra R&D also increases the company's base for each of the succeeding three years, reducing the credit the company gets in those years on other R&D. The cumulative result is a wash. The company does get use of the credit dollars for an average of two years. This provides some incentive to invest in extra R&D, but only about 2-3% before tax.

The analysis is different on different facts about the extra R&D -- for example, if the company were to keep spending an extra $12 million per year indefinitely -- but the bottom line is the same. The incentive amounts to only 2-3% a year.

The proposed modified structure achieves the original intent -- it cuts the cost of extra R&D by the full rate of the credit[1]. There are refinements and other improvements -- for example, to make startup firms eligible -- but this is the key improvement.

Current Structure (Rolling Base)

YEAR	BEFORE TAX COST	TAX EFFECT	AFTER TAX COST
1	$12,000,000	$2,400,000	$9,600,000
2	$0	($800,000)	$800,000
3	$0	($800,000)	$800,000
4	$0	($800,000)	$800,000
5	$0	$0	$0
Cumulative	$12,000,000	($0)	$12,000,000

Proposed Structure (Indexed Fixed Base)

YEAR	BEFORE TAX COST	TAX EFFECT	AFTER TAX COST
1	$12,000,000	$2,400,000	$9,600,000
2	$0	$0	$0
3	$0	$0	$0
4	$0	$0	$0
5	$0	$0	$0
Cumulative	$12,000,000	$2,400,000	$9,600,000

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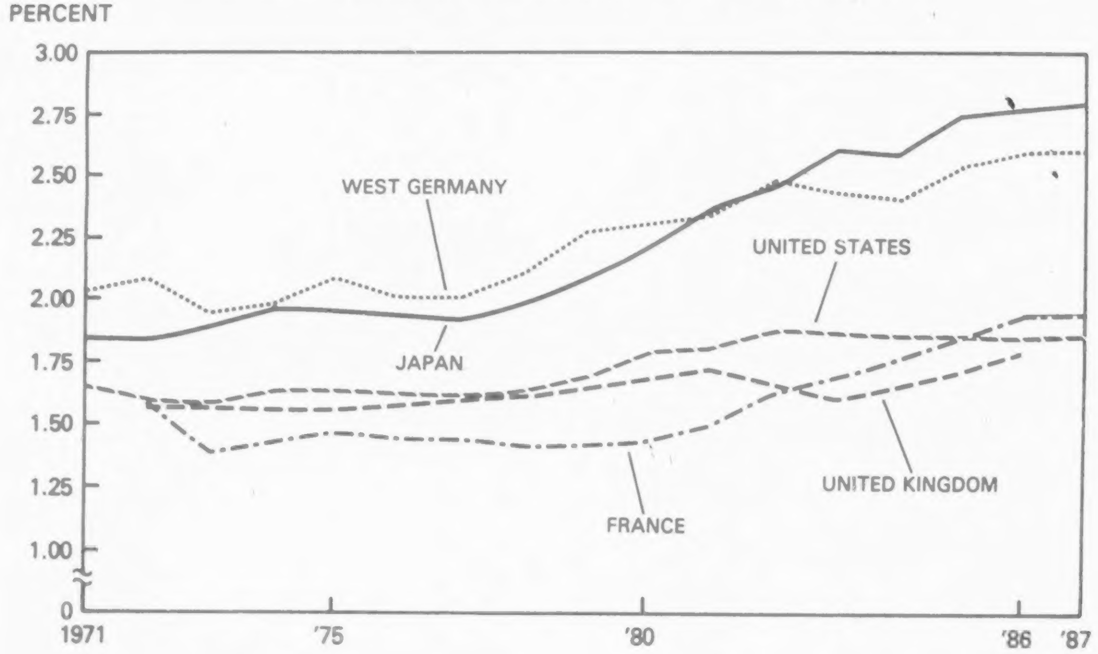
[1] Except as affected by the accompanying deduction disallowance, which affects either credit structure, but for simplicity is disregarded in this example.

NON-DEFENSE R&D EXPENDITURES AS A PERCENT OF GROSS NATIONAL PRODUCT (GNP) BY COUNTRY



SOURCE: DIVISION OF SCIENCE RESOURCES STUDIES.

STATEMENT OF HON. FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and Members of the Committee on Ways and Means:

As Chief Counsel for Advocacy, U.S. Small Business Administration, I am pleased to submit this statement on the Administration's proposal to extend and improve the Research and Experimentation (R&E) Tax Credit. My views here today reflect those of the SBA and the Administration.

It is both appropriate and important that small business be heard on this issue. Research studies funded by the Office of Advocacy have shown small firms to be prodigious innovators: innovating at a rate twice that of large firms per employee,[1] spending twice the percentage of their research and development budget on basic research, as opposed to applied research or development,[2] and creating more than 20 times the innovations for the same amount of R&E tax credit claimed.[3] Despite this, the design of our current credit structure has prevented small business from fully utilizing the credit or receiving an equitable share of its benefits. Moreover, the credit has been completely denied to start-up firms in their efforts to develop innovative products vital to America's continued competitiveness. I strongly support the enactment of a permanent R&E Tax Credit to replace the current credit, which was extended in the Technical and Miscellaneous Revenue Act of 1988 until December 31, 1989. I believe, however, that the credit must be restructured to give small firms needed incentives to perform R&E.

The Administration proposal under consideration by this Committee would introduce much needed changes to the credit structure, substantially improving its effectiveness and enhancing small businesses' ability to innovate. The proposal is similar to S.2484, which was introduced by Senators Danforth and Baucus in the 100th Congress. S.2484 was the product of collective efforts to address the credit's structural problems by Congress, the business community - both large and small, the Department of Treasury, and government representatives from the Small Business Administration, the Department of Commerce, and the National Science Foundation. Legislation containing many of the essential reforms of S.2484 and the Administration proposal has been introduced in the 101st Congress - S.570 and H.R. 1416.

The current R&E tax credit, codified in Section 41 of the Internal Revenue Code (I.R.C.), applies to the increase of the present year's qualified R&E expenses over a "base," which is generally the average annual amount of qualified R&E expenditures over the three years preceding the year in which the credit is being claimed. As an important limitation, I.R.C. § 41(b)(1) restricts creditable expenditures to those incurred "in carrying on" an existing trade or business.[4]

The Administration proposal would extend the credit to new firms and firms expanding into new trades or businesses, provided those firms intend to use the research in the active conduct of a future trade or business. This change would effectively remove the "in carrying on" restriction, which was developed before the passive loss rules to restrict taxpayer activity. Because of the "in carrying on" restriction, the R&E expenses leading to many of America's most significant small business innovations would not have been eligible for the credit. This includes the R&E leading to the development of magnetic resonance imaging, the six-axis robot arm, the airplane, the helicopter, the human growth hormone, the Polaroid camera, the programmable computer, the super computer, and the personal computer. In fact, the most significant innovations by definition involve a new line of business and would not be eligible for the existing credit. By allowing the credit to be taken by firms who have not yet brought their products to market, the legislation will remove a long-standing problem and further encourage small firm innovation.

Equally important, the legislation would eliminate features that have discouraged established businesses from fully utilizing the credit. Because the credit is tied to previous years' R&E expenditures, a firm's expenditures in one year serve to block availability of the credit for that firm in future years. In order to maximize the credit, some firms have been artificially induced to postpone R&E spending or adjust their R&E spending downward. This problem, acute in small firms, would be obviated by replacing the "moving-base" with a "fixed-base," smoothly phased in for new companies. A "fixed-based" credit, unaffected by a firm's current year R&E expenditures, would provide a constant, predictable incentive to perform R&E. Incentives for increasing R&E intended by current law would be preserved under the Administration's proposal, while existing disincentives would be ameliorated. The very nature of the current incremental tax credit system, since firms can not increase their research expenditures indefinitely, is philosophically inconsistent with a permanent credit. A secondary feature of the credit would widen availability of the credit by enabling firms that do not happen to be in high growth industries, but which still perform significant R&E, to take a reduced credit.

The restructured credit proposed by the Administration would provide an effective, permanent incentive for R&E. This type of incentive is essential for international competitiveness and has been long overdue.

I. Small Business Need for the R&E Credit

Small firms may be reluctant to direct money to R&E because of the difficulty they experience in recapturing profit from their efforts. With less market identity and smaller distribution networks, they may lack the ability to rapidly penetrate markets, particularly when products or processes do not enjoy intellectual property protection. Even when the potential societal benefits of an innovation exceed the costs of research and development, small firms may not be able to translate enough of those benefits into their own profit to afford R&E investment. In many cases, small firms generate ideas, only to see the final product manufactured and sold by other firms, domestic and foreign. A well-designed credit would serve to close the gap between the benefit enjoyed by society from an innovation and the economic benefit recovered by the innovating firm.

In addition, a new R&E tax credit is needed to offset the costs of financing research, which will in turn decrease the risk to potential investors in small firms. Small firms, when performing research, must often rely on expensive, private sources of financing, and do not have access to traditional debt and equity markets as do large firms. This reliance on external financing often presents small firms with a unique problem: whether or not to expose their innovations to potential investors. The problem is particularly acute when these firms rely on a single, cherished innovation. Moreover, potential investors may be dissuaded from investing in R&E - intensive small firms because of the inherent financial risks of R&E projects. A restructured credit will assist both established and start-up firms in securing financing by increasing the after-tax profits earnable by investors in successful ventures.

Finally, a new R&E credit is necessary to give all American businesses incentives to perform private sector R&E. Many of our economic competitors currently provide significant incentives for private R&E. Japan, for example, targets a substantial flat credit for R&E expenditures to small and medium-sized businesses. Under Japanese law, a taxpayer with fewer than 1,000 employees, in lieu of a 20 percent incremental tax credit, may elect a flat tax credit equal to 6 percent of qualified R&E expenses or 5 percent of the income tax on business income before the credit, whichever is smaller. Also, Japan accords a 7 percent credit on the acquisition or manufacturing cost of high-technology machinery.[5]

The Korean tax system also offers substantial tax incentives for stimulating innovation. Small to medium-sized companies engaged in a technology-intensive enterprise may be exempted from income taxes for the first four years of operation and are only required to pay taxes at a 50 percent of the normal rates for a period of two years, before being phased-in to normal tax rates. Manufacturing and other specific industries are given a 10 percent flat tax credit for expenses relating to development of technology, in addition to a 10 percent incremental credit for the amount those expenditures exceed the previous two year's average, taken out of a investment reserve. Persons investing in a business which utilizes a new technique are also given a tax credit of 3 to 10 percent of the amount invested. They are also permitted to depreciate 30 to 50 percent of the value of the acquired assets in the first year of acquisition, depending upon whether or not Korean-manufactured assets were acquired. Investments for facilities used for research and experimentation are given an 8 percent credit and a 90 percent deduction in the year of acquisition. Furthermore, income derived from a patent is generally free from tax, except that royalty income is taxed after a period of five years.[6] If America is to maintain her technological lead, we must have a strong commitment to private sector R&E.

II. Small Business Problems with the Current R&E Tax Credit

A. The Current Credit is Inequitably Distributed

The Federal incentive resulting from the R&E tax credit is not available to small firms to the same extent as large firms, even though small firms are more innovative per employee than large firms. Chart 10 of Attachment 1, which shows the approximate tax credit cost per innovation as a function of firm size, indicates that small firms produce more than 20 times the innovations per dollar of tax credit claimed than do large firms. In particular, small firms produce 141 innovations per million dollars of tax credit claimed, while large firms produce 5.3 innovations per million dollars of tax credit claimed. Thus, large firms receive almost $190,000 in Federal tax subsidy for every innovation they introduced while small firms receive less than $7,100.[7]

The Corporate Statistics of Income (SOI) data for 1985 indicate that the use of the R&E credit increases with the size of a firm. For example, in 1985 a firm with an average of 168 employees claimed $11.59 in credits for every $100,000 in business receipts, while a firm of 1,319 employees claimed, on the average, $23.94 in credits for every $100,000 in business receipts (See Chart 3 of Attachment 1). Chart 9 shows a similar pattern in the research-intensive manufacturing sector (see Charts 3, 6 and 9 of Attachment 1), which is estimated by the GAO to utilize 82.3 percent of the current R&E tax credit. According to the GAO, 77.6 percent of the R&E credit went to manufacturing firms (large and small) between 1981 and 1984.[8] A recent Office of Advocacy funded study of large and small industrial firms in upstate New York found that more than 50 percent of the small firms had at least one person devoted full-time to research and development.[9] Extrapolating these figures by detailed firm size across the total U.S. population of 358,000 manufacturing firms suggests that 100,000 small firms perform research which may qualify for the credit. Small corporations (under $250 million in assets) and individuals received 22.4 percent of the credit between 1981 and 1984.[10]

SBA has analyzed the effect of S.570 and H.R.1416 on hypothetical firms with different R&E spending patterns in Attachment 2. In general, firms -- large and small, new or established -- would greatly improve their position under these proposals over current law. Start-up firms would benefit because of the smooth phase-in "base" calculation for these firms and because of the extension of the credit to new businesses. The only firms not benefiting, cyclical spending firms, would be discouraged from purposefully increasing and decreasing their expenditures in order to maximize the credit. I would refer you to Attachment 2 for a more complete analysis of the impacts of these proposals on hypothetical firms.

B. The Current Credit is Denied to Start-up Firms

One of the principal problems with the current credit is that it is misdirected, disqualifying expenditures by new firms and firms branching into new trades or businesses while rewarding incremental improvements in existing technologies or product lines. The "in carrying on" limitation was originally enacted to prevent taxpayers from investing in abusive R&E tax shelters. This was at a time when passive losses and credits could offset active income. The creation of the passive loss rules has generally obviated the need for this restriction as a safeguard for research conducted by individuals through proprietorships, partnerships, and S corporations, and the negative effect of the "in carrying on" limitation remains for all new research-oriented firms regardless of their form. These firms typically expend substantial amounts on R&E costs over many years before their product is marketable. I believe this restriction is one significant factor contributing to the less frequent use of the R&E credit by small firms relative to large firms.

C. The Current Credit Structure Interferes with Market Strategy

The current credit system also tends to interfere with, rather than augment, sound market decisions. The "moving base" structure of the current credit, which dictates how much credit a firm can take, is intended to stimulate continued annual increases in R&E spending by applying the credit rate to the difference between current year R&E spending and the average spending level for immediately preceding years. However, the current structure enables a firm to influence the amount of future credit by adjusting its R&E spending, elevating tax strategy over market strategy.

Under the current credit, if expenditures for R&E are made that equal or fall below the average "base," the tax credit for those expenses will be permanently lost. Likewise, when growth rates accelerate or fluctuate, as is the case for many start-up companies, the floor as contained in I.R.C.

§ 41(c)(3) may be reached.[11] While these features are also true of the proposed fixed-base credit, the current structure compounds the negative effect because R&E expenses that are not creditable will nevertheless be added to the "base" to reduce or eliminate the credit in later years. A firm will, therefore, gain no tax advantage from expending money for R&E in an amount which falls below the "base" or floor, even though these expenses may be increases over the preceding year, which are meant to be encouraged through the incremental structure. Sound tax planning would instead encourage a firm to forgo research to reduce the spending "base" or avoid the floor limitation. Larger firms are also encouraged to redirect research funds among their trades or businesses so that the firms' overall tax benefit will be maximized.

Since the value of the credit can be optimized by steadily increasing expenditures, firms that can assume a more steady R&E growth posture are favored over those that cannot. Firms that cannot steadily control their expenditure level, typically smaller firms, are encouraged to purposefully cycle their R&E expenditures in order to maximize the credit.

Furthermore, by tying a firm's credit to preceding years' spending levels, the structure ensures the disproportionate distribution of the subsidy to firms which happen to be in high-growth fields relative to firms in slow-growth fields, which may nonetheless be emerging technologies. Since high-growth firms tend to naturally increase research expenditures as sales increase, the credit's incentive effect is reduced.

III. Reinstatement Of An Effective Capital Gains Differential

Reinstatement of an effective capital gains differential is an essential element of our strategy for competitiveness as a necessary corollary to the permanent extension and improvement of the R&E Tax Credit. It is critical that we ensure a favorable flow of informal capital through our tax code, by rewarding -- or at least not discouraging -- main stream investment in small and emerging companies.

A tax differential for long term capital gains is critical to our Nation's prosperity and competitiveness. Favorable capital gains treatment is needed to ensure that investors are willing to invest in, and stay invested in, growth businesses. Without such a differential, small business has problems in attracting patient capital,-- capital which focuses on long-term growth, instead of short term profits. In the absence of a differential favoring long term gains it is often less risky to seek returns based on next quarter's profit and loss statement, or to rely on a steady stream of interest or dividend income, than to wait while a firm innovates, grows and opens new markets. Investors currently receive the same tax treatment if an investment is held for five years or five minutes. By orienting investors towards long-term investments, the President's capital gains proposal will encourage corporate managers to take a far-sighted approach to corporate planning, stimulating investment in R&E and in our future.

Research commissioned by SBA demonstrates that informal equity investors in small firms are a much larger financing factor than venture capital. Our studies show that the informal investor network creates an infusion of capital at the critical initial stages of firm development, before venture capital or public sources of financing are available. And it is apparent, from the characteristics of participants in this informal investor network, that the network would benefit greatly from a reinstatement of capital gains. We know, for example, that the majority of firms invested in are very small -- 90 percent have under 20 employees -- and very young -- 70 percent have been in existence for less than one year. In addition, we know that these investors are also not wealthy by traditional standards. Stimulating this continual informal investment through enactment of the President's capital gains proposal is an essential small business issue.

Further, the Treasury Department's estimates show that the President's capital gains proposal is a revenue raiser in both the short run and the long run. The proposal would raise $4.8 billion in fiscal year 1990 and $16.1 billion through fiscal year 1993. In the long run, after the phase-in of the three year holding period, the proposal would raise nearly $2 billion per year. Finally, the U.S. remains one of the few advanced economies without some form of capital gains differential. Sweden and France have reduced rates on capital gains, while Italy, France, South Korea, Taiwan and other growing economies have exempted capital gains entirely from taxation. In Canada, there is lifetime exemption on the first $500,000 of capital gains for the owner of a business and $100,00 for all other investors. Reinstatement of a capital gains differential is a small business priority.

IV. Conclusion and Recommendations

An R&E tax credit is a vital incentive for performing innovative research by small and large firms, yet, as currently constituted, it is inefficiently and ineffectively designed. Ensuring the proper distribution of the credit among firm sizes and industries, reducing disincentives to invest in R&E, especially for small firms, and making the credit more efficient must be the goals of any restructuring of the R&E credit. In addition, it is important to our Nation's competitiveness that we reinstate an effective capital gains differential.

I urge the Committee to adopt legislation that accomplishes these important goals. The reforms contained in the Administration proposal will eliminate negative incentives for performing R&E by severing the connection between the amount of credit available to a firm and its immediate past R&E expenditures. The proposal would also ensure that the credit stimulates new product and technological development by effectively eliminating the "in carrying on" limitation. Finally, the new R&E tax credit structure would greatly widen the credit's availability among slower growth firms through the secondary credit calculation.

Reform of the credit and its permanent extension will assist all firms in developing the products and processes which are vital to America's international competitiveness. Making the credit more available to small businesses will return the greatest number of innovations per dollar of tax subsidy.

1. Gellman Research Associates, The Relationship Between Industrial Concentration, Firm Size and Technological Innovation (Washington, D.C., U.S. Small Business Administration, Office of Advocacy, May 1982, NTIS #PB82226119); The Futures Group, Characterization of Innovations Introduced on the U.S. Market in 1982 (Washington, D.C.: U.S. Small Business Administration, Office of Advocacy, March 1984, NTIS #PB84 212067). According to the Gellman study, small firms create 2.45 times as many innovations per employee than do large

firms. The Futures Group supported this conclusion at a rate of 2.38, finding that on a per employee basis small firms are 1.91 times as likely as large businesses to make first-of-type innovations, and 2.46 times as likely to make modest improvements in existing technology.

2. U.S. National Science Foundation, Trends to 1982 in Industrial Support of Basic Research (Washington, D.C.: U.S. Government Printing Office; 1983, NSF 83-302), Table B-2.

3. See Chart 10 Attachment 1. This statistic was derived from combining data from three sources: (1) the IRS/SBA Match File (1979), which links size of firm by asset category to average firm employment; (2) the IRS 1985 Statistics of Income; (3) and the Futures Group Study (id. at note 1).

4. A distinction between IRC § 41 and § 174, which permits expensing in connection with a trade or business, was explored in Snow v. Commissioner, 416 U.S. 500 (1974).

5. YOJI GOMI, Guide to Japanese Taxes, 1986-87, Tokyo; Zaikei Shoho Sha (Published in 1986) p. 126.

6. Tax Reduction and Exemption Control Act, amended by Law No. 3939, November 28, 1987, Republic of Korea.

7. Id. at note 3.

8. Briefing Report to the Honorable Brian Donnelly, U.S. House of Representatives, Preliminary Analysis of the Research and Experimentation Tax Credit, Government Accounting Office, June 1988 (GAO/GGD-88-98BR) and accompanying letter dated June 17, 1988. The statistic tracks data from 1981 to 1984.

9. Albert N. Link and Barry Bozeman, Firm Size and Innovative Activity: A Further Examination, (Washington, D.C.: U.S. Small Business Administration, Office of Advocacy, under award no. SBA-2069-OA-87, September 1987).

10. Id. at note 7.

11. This limitation statutorily restricts annual qualified expenditures to the lesser of - 50 percent of the current year R & E expenditures or the increase in those expenditures over the average spent in the three previous years. In practice, the 50 percent limitation applies when R & E expenses annually increase at an effective rate of about 45 percent.

ATTACHMENT 1

Table 1: Fast Growth Firm (+12%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GMP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	105.55						
1985	119.94						
1986	136.29						
1987	154.88						
1988	176.00						
1989	200.00						
1990	224.00	176.96	9.41	144.84	15.83	8.08	15.83
1991	250.88	200.00	10.18	148.46	20.48	9.77	20.48
1992	280.99	224.96	11.21	152.17	25.76	11.68	25.76
1993	314.70	251.96	12.55	155.97	31.75	13.84	31.75
1994	352.47	282.19	14.06	159.87	38.52	16.28	38.52
Total Credit ('90 to '94)			57.39		132.35	59.64	132.35

Table 2: Medium Growth Firm (+7%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	139.14						
1985	149.61						
1986	160.87						
1987	172.98						
1988	186.00						
1989	200.00						
1990	214.00	186.33	5.53	169.08	8.98	6.10	8.98
1991	228.98	200.00	5.80	173.31	11.13	6.93	11.13
1992	245.01	214.33	6.14	177.64	13.47	7.82	13.47
1993	262.16	229.33	6.57	182.08	16.02	8.79	16.02
1994	280.51	245.38	7.03	186.63	18.78	9.84	18.78
Total Credit ('90 to '94)			31.06		68.39	39.49	68.39

Table 3: Slow Growth Firm (+3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	171.75						
1985	177.06						
1986	182.53						
1987	188.18						
1988	194.00						
1989	200.00						
1990	206.00	194.06	2.39	191.02	3.00	4.39	4.39
1991	212.18	200.00	2.44	195.79	3.28	4.57	4.57
1992	218.55	206.06	2.50	200.69	3.57	4.76	4.76
1993	225.10	212.24	2.57	205.70	3.88	4.96	4.96
1994	231.85	218.61	2.65	210.85	4.20	5.16	5.16
Total Credit ('90 to '94)			12.54		17.93	23.85	23.85

Table 4: Zero Growth Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	200.00						
1985	200.00						
1986	200.00						
1987	200.00						
1988	200.00						
1989	200.00						
1990	200.00	200.00	0.00	209.10	0.00	3.02	3.02
1991	200.00	200.00	0.00	214.33	0.00	2.75	2.75
1992	200.00	200.00	0.00	219.69	0.00	2.47	2.47
1993	200.00	200.00	0.00	225.18	0.00	2.18	2.18
1994	200.00	200.00	0.00	230.81	0.00	1.88	1.88
Total Credit ('90 to '94)			0.00		0.00	12.30	12.30

Table 5: Negative Growth Firm (-1%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	210.20						
1985	208.12						
1986	206.06						
1987	204.02						
1988	202.00						
1989	200.00						
1990	198.00	202.01	0.00	215.46	0.00	2.55	2.55
1991	196.02	200.00	0.00	220.84	0.00	2.13	2.13
1992	194.06	198.01	0.00	226.36	0.00	1.70	1.70
1993	192.12	196.03	0.00	232.02	0.00	1.27	1.27
1994	190.20	194.07	0.00	237.82	0.00	0.83	0.83
Total Credit ('90 to '94)			0.00		0.00	8.47	8.47

Table 6: Negative Growth Firm (-3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	231.85						
1985	225.10						
1986	218.55						
1987	212.18						
1988	206.00						
1989	200.00						
1990	194.00	206.06	0.00	228.69	0.00	1.57	1.57
1991	188.18	200.00	0.00	234.41	0.00	0.87	0.87
1992	182.53	194.06	0.00	240.27	0.00	0.16	0.16
1993	177.06	188.24	0.00	246.27	0.00	0.00	0.00
1994	171.75	182.59	0.00	252.43	0.00	0.00	0.00
Total Credit ('90 to '94)			0.00		0.00	2.60	2.60

Table 7: Mildly Cyclical Firms

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP + 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	175.00						
1985	150.00						
1986	125.00						
1987	165.00						
1988	180.00						
1989	200.00						
1990	175.00	181.67	0.00	166.23	1.75	3.52	3.52
1991	150.00	185.00	0.00	170.39	0.00	1.55	1.55
1992	125.00	175.00	0.00	174.65	0.00	0.00	0.00
1993	165.00	150.00	3.00	179.02	0.00	2.15	2.15
1994	180.00	146.67	6.67	183.49	0.00	2.97	2.97
Total Credit ('90 to '94)			9.67		1.75	10.20	10.20

Table 8: Highly Cyclical Firms

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	25.00						
1985	115.00						
1986	235.00						
1987	50.00						
1988	75.00						
1989	200.00						
1990	100.00	108.33	0.00	104.55	0.00	1.51	1.51
1991	45.00	125.00	0.00	107.16	0.00	0.00	0.00
1992	250.00	115.00	27.00	109.84	28.03	11.73	11.73
1993	180.00	131.67	9.67	112.59	13.48	6.69	13.48
1994	65.00	158.33	0.00	115.40	0.00	0.00	0.00
Total Credit ('90 to '94)			36.67		41.51	19.93	26.72

Table 9: Fast Growth Start-up Firm (+12%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	154.88						
1988	176.00						
1989	200.00						
1990	224.00	176.96	9.41	0.00	22.40	15.68	22.40
1991	250.88	200.00	10.18	0.00	25.08	17.56	25.08
1992	280.99	224.96	11.21	0.00	28.09	19.67	28.09
1993	314.70	251.96	12.55	83.99	31.47	17.62	31.47
1994	352.47	282.19	14.06	131.19	35.25	17.79	35.25
1995	394.76	316.05	15.74	184.06	39.48	17.97	39.48
1996	442.14	353.98	17.63	188.66	44.21	21.04	44.21
1997	495.19	396.46	19.75	193.38	49.52	24.51	49.52
Total Credit ('90 to '97)			110.52		275.50	151.84	275.50

Table 10: Medium Growth Start-up Firm (+7%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	172.98						
1988	186.00						
1989	200.00						
1990	214.00	186.33	5.53	0.00	21.40	14.98	21.40
1991	228.98	200.00	5.80	0.00	22.90	16.03	22.90
1992	245.01	214.33	6.14	0.00	24.50	17.15	24.50
1993	262.16	229.33	6.57	76.44	26.22	14.34	26.22
1994	280.51	245.38	7.03	115.77	28.05	13.56	28.05
1995	300.15	262.56	7.52	157.84	30.02	12.72	30.02
1996	321.16	280.94	8.04	161.79	31.87	13.99	31.87
1997	343.64	300.60	8.61	165.83	34.36	15.35	34.36
Total Credit ('90 to '97)			55.23		219.32	118.11	219.32

Table 11: Slow Growth Start-up Firm (+3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	188.18						
1988	194.00						
1989	200.00						
1990	206.00	194.06	2.39	0.00	20.60	14.42	20.60
1991	212.18	200.00	2.44	0.00	21.22	14.85	21.22
1992	218.55	206.06	2.50	0.00	21.86	15.30	21.86
1993	225.10	212.24	2.57	70.75	22.51	12.04	22.51
1994	231.85	218.61	2.65	104.51	23.19	10.74	23.19
1995	238.81	225.17	2.73	139.29	19.90	9.40	19.90
1996	245.97	231.92	2.81	142.77	20.64	9.72	20.64
1997	253.35	238.88	2.89	146.34	21.40	10.05	21.40
Total Credit ('90 to '97)			20.98		171.33	96.54	171.33

Table 12: Zero Growth Start-up Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	200.00						
1988	200.00						
1989	200.00						
1990	200.00	200.00	0.00	0.00	20.00	14.00	20.00
1991	200.00	200.00	0.00	0.00	20.00	14.00	20.00
1992	200.00	200.00	0.00	0.00	20.00	14.00	20.00
1993	200.00	200.00	0.00	66.67	20.00	10.50	20.00
1994	200.00	200.00	0.00	96.67	20.00	8.93	20.00
1995	200.00	200.00	0.00	126.67	14.67	7.35	14.67
1996	200.00	200.00	0.00	129.83	14.03	7.18	14.03
1997	200.00	200.00	0.00	133.08	13.38	7.01	13.38
Total Credit ('90 to '97)			0.00		142.08	82.97	142.08

Table 13: Negative Growth Start-up Firm (-1%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	204.02						
1988	202.00						
1989	200.00						
1990	198.00	202.01	0.00	0.00	19.80	13.86	19.80
1991	196.02	200.00	0.00	0.00	19.60	13.72	19.60
1992	194.06	198.01	0.00	0.00	19.41	13.58	19.41
1993	192.12	196.03	0.00	65.34	19.21	10.02	19.21
1994	190.20	194.07	0.00	94.16	19.02	8.37	19.02
1995	188.30	192.13	0.00	122.69	13.12	6.74	13.12
1996	186.41	190.20	0.00	125.76	12.13	6.45	12.13
1997	184.55	188.30	0.00	128.90	11.13	6.15	11.13
Total Credit ('90 to '97)			0.00		133.42	78.89	133.42

Table 14: Negative Growth Start-up Firm (-3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	212.18						
1988	206.00						
1989	200.00						
1990	194.00	206.06	0.00	0.00	19.40	13.58	19.40
1991	188.18	200.00	0.00	0.00	18.82	13.17	18.82
1992	182.53	194.06	0.00	0.00	18.25	12.78	18.25
1993	177.06	188.24	0.00	62.75	17.71	9.10	17.71
1994	171.75	182.59	0.00	89.30	16.49	7.33	16.49
1995	166.59	177.11	0.00	115.07	10.31	5.62	10.31
1996	161.60	171.80	0.00	117.94	8.73	5.12	8.73
1997	156.75	166.65	0.00	120.89	7.17	4.63	7.17
Total Credit ('90 to '97)			0.00		116.88	71.33	116.88

Table 15: Mildly Cyclical Spending Start-up Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	165.00						
1988	180.00						
1989	200.00						
1990	175.00	181.67	0.00	0.00	17.50	12.25	17.50
1991	150.00	185.00	0.00	0.00	15.00	10.50	15.00
1992	125.00	175.00	0.00	0.00	12.50	8.75	12.50
1993	165.00	150.00	3.00	50.00	16.50	8.93	16.50
1994	180.00	146.67	6.67	74.75	18.00	8.68	18.00
1995	125.00	156.67	0.00	101.75	4.65	3.41	4.65
1996	150.00	156.67	0.00	104.29	9.14	5.02	9.14
1997	175.00	151.67	4.67	106.90	13.62	6.64	13.62
Total Credit ('90 to '97)			14.33		106.91	64.17	106.91

Table 16: Highly Cyclical Spending Start-up Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Base Current Law	Credit $ Current Law	Base Primary GNP = 2.5%	Credit $ Primary 20%	Credit Secondary 7% + 75% of Base	Maximum Credit $ Available
1987	50.00						
1988	75.00						
1989	200.00						
1990	100.00	108.33	0.00	0.00	10.00	7.00	10.00
1991	45.00	125.00	0.00	0.00	4.50	3.15	4.50
1992	250.00	115.00	27.00	0.00	25.00	17.50	25.00
1993	180.00	131.67	9.67	43.89	18.00	10.30	18.00
1994	65.00	158.33	0.00	70.89	0.00	0.83	0.83
1995	235.00	165.00	14.00	80.64	23.50	12.22	12.22
1996	115.00	160.00	0.00	82.65	6.47	3.71	3.71
1997	25.00	138.33	0.00	84.72	0.00	0.00	0.00
Total Credit ('90 to '97)			50.67		87.47	54.70	74.26

Notes on Attached Charts

The Statistics of Income (SOI) data of the Internal Revenue Service (IRS) are devoid of employment data. The published SOI data are arrayed by firm asset size class.

However, the 1979 IRS/SBA MATCH file contains SOI data augmented with employment data augmented with employment data (as recorded on the Employers' Federal Quarterly Tax Return). These data allow the calculation of the average firm employment size (i.e., average number of employees per firm) by firm asset size class and industry.

The crosswalk between asset size and employment size that is facilitated by the MATCH file was used to estimate the number of employees associated with the returns represented in an SOI asset size cell.

The firm employment size classes that are arrayed along the horizontal axes of the attached charts are simply the average number of employees per firm within each of the SOI asset size classes.

Charts 1, 2 and 3. R&D Tax Credit Claimed Per Dollar of Receipts by Firm Employment Size in 1983, 1984, and 1985

For each asset size class and year, the total research activities credit claimed was divided by business receipts (in $100,000 units). The result is the R&D credit claimed relative to revenues. This ratio was then plotted as a function of firm employment size. Charts 1, 2, and 3 clearly show that the R&D credit claim per dollar of revenue falls as the average firm employment size falls.

Charts 4, 5, and 6. R&D Tax Credit Claimed per Employee by Firm Employment Size in 1983, 1984, and 1985

The total research activities credit for each asset size class was divided by the number of employees estimated to be represented by that asset size class. (In particular, the average number of employees per return within an asset size class was multiplied by the number of returns represented by that size class.) Charts 4, 5, and 6 show that the R&D tax credit claimed rises with firm employment size, even on a per employee basis.

Charts 7, 8, and 9. R&D Tax Credit Claimed per Dollar of Reciepts by Firm Employment Size 1983, 1984, 1985: SIC 20-39

The data displayed in this chart were derived in a manner analogous to those displayed in Charts 1, 2 and 3, except that the tax credit data and asset-employee relationships pertain expressly to manufacturing firms (SIC Codes 20-39).

Chart 10. Innovations per R&D Tax Credit Claimed: Small Firms vs. Large Firms

Using 1985 SOI data and the 1979 IRS/SBA Match file the employment by asset category for the first 7 categories (up to $25 million in assets) were summed to get the total employment of small firms. The employment associated with the 4 largest asset size classes was aggregated to get the total employment of large firms.

The R&D tax credits claimed were aggregated into small and large firm categories in a manner analogous to the employment aggregation, described above.

The results of the 1982 Futures Group study (published in 1984) of innovations by firm size, which found that small firms produce an estimated 745 innovations per million employees and that large firms produce 313 innovations per million employees, were used to derive estimates of the number of innovations produced by small firms (19,431) and by large firms (7,715). These numbers were then divided by the total R&D tax credit claimed by small and large firms, respectively, to obtain the number of innovations per dollar of R&D tax credit claimed for small vs. large firms.

Results:

Small Firms	Large Firms
141.7 innovations per million dollars in R&D tax credit claimed.	5.3 innovations per million dollars in R&D tax credit claimed.

A Note on Possible Future Tabulations

The 1982 MATCH file has recently been developed which means that the data arrayed in these charts could be recalculated using the more current 1982 MATCH file asset-per-employee ratios.

Since there was substantial inflation between 1979 and 1982, the average firm employment size within firm asset size classes probably shrank between 1979 and 1982. This possibility should not, however, seriously impair the credibility of the data presented here.

ATTACHMENT 2

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

Analysis of S. 570 and H.R. 1416 the "Research and Experimental Credit Extension and Reform Act of 1989"

The attached Tables 1 through 8 model the effect on hypothetical firms of the current Research and Experimentation Tax Credit (I.R.C. §41) and two identical proposals to modify the credit, S. 570 and H.R. 1416. Specifically, current law and the proposal are modeled over a five year period, between 1990 and 1994, to determine its effect on two factors: the calculation of the tax credit and the "historical base", from which tax credit is calculated. The hypothetical firms are divided into four general categories of spending patterns: growing, constant, declining, and cyclical. Tables 9 through 16 model the same spending patterns for the same years, but indicate the effects of the S.570 and H.R. 1416 versus current law on new and start-up firms. All firms were assumed to have R & E expenditures of $200,000 in 1989.

Start-up firms are treated separately under the models (tables 9-16) because under current law they are not eligible to use the credit. Therefore, tables 9 through 16 are a comparison of S.570 and H.R.1416 to other proposals which would allow start-ups to take the credit, but not otherwise change the current structure of the credit. Tables 9-16 also assume that each start-up firm came into existence in 1987. For some of these firms, negative R & E growth is assumed to occur.

Summary of Analysis

According to the analysis, established firms show substantial increases in credit received in every R & E spending scenario except "cyclical". Fast growth firms (12% annual R & E increases) more than doubled their credit, increasing it from $57,390 to $132,350 for 1990 - 1994. At the other extreme, highly cyclical spending firms decreased their credit from $36,670 to $26,720, while mildly cyclical firms' credit increased from $9,670 to $10,200. Therefore, in our hypothetical spending scenarios, both S.570 and H.R. 1416 would provide a disincentive for firms to cycle their R & E spending. At the same time it would encourage increased R & E spending by allowing greater credit rewards.

Under S.570 and H.R. 1416 both proposals start-up firms receive more tax credit than under the current credit structure. Fast growing firms receive $275,500 under these proposals as compared with $110,520 under current law (assuming start-ups are eligible) for 1990-1997. Even highly cyclical firms receive more under the new legislation, $74,260 versus $50,760, due mainly to the base phase-in rules in Section 3.

Description of S. 570 and H.R. 1416

The major distinction between S. 570 or H.R. 1416 and current law lies in the calculation of the base, upon which the credit is determined. The new legislation utilizes a fixed-base, the so-called "historic base period amount," which freezes a firm's historic spending level. Current law, on the other hand, uses a moving-base, which is calculated with reference to a firm's expenditures for the three immediately preceding years. A firm's fixed-base under this proposal would be equal to its average annual R & E expenditure in 1984 through 1988 plus 2%. Beginning in 1990 this base amount would be indexed by the three year average increase in GNP. One important restriction is that it can never be less than 50% of current expenditures when calculating a firm's credit.

Once the historical base period amount is determined, a firm has a choice of calculating its credit one of two ways: it can subtract its current R & E expenditures from its base and take 20% of the difference as its credit; or, it can subtract its current R & E expenditures from 75% of its base and take 7% of the difference as its credit. The latter calculation is referred to as either the "alternative credit calculation" or the "secondary credit". However, a firm must make an irrevocable election to use only one type of credit calculation for three taxable years.

S.570 and H.R. 1416 would make most start-up firms eligible for the credit. Firms which did not have R & E expenditures in at least three of the years during the period between 1984 and 1988, including firms which come into existence after 1989, would calculate their R & E base as described below. For a firm's first three years of R & E spending the base would be zero. In the fourth year, the base would equal one-third of the average R & E spending in the first three years. In the fifth year, the base would equal the fourth year base plus 15% of fourth year R & E expenditures. In the sixth year, the base would equal the fifth year base plus 15% of fifth year R & E expenditures. Thereafter, the "historical base period amount" would be fully phased in, and the base would be increased by annual GNP growth. Start-up firms would also be subject to the 50% of current expenditures base limitation.

Established Firm Tables:

- Table 1 represents fast-growth firms that increase their R & E spending at a rate of 12 percent.
- Table 2 represents medium-growth firms that increase their R & E spending at a rate of 7 percent.
- Table 3 represents slow-growth firms that increase their R & E spending at rate of 3 percent.
- Table 4 represents firms that maintain a constant R & E spending level.
- Table 5 represents firms that decrease their R & E spending at a rate of 1 percent annually.
- Table 6 represents firms that decrease their R & E spending at a rate of 3 percent annually.
- Table 7 represents firms with mildly cyclical R & E spending patterns.
- Table 8 represent firms with highly cyclical R & E spending patterns.

Start-Up Firm Tables:

- Table 9 represents fast-growth start-up firms that increase their R & E spending at a rate of 12 percent.
- Table 10 represents medium-growth start-up firms that increase their R & E spending at a rate of 7 percent.
- Table 11 represents slow-growth start-up firms that increase their R & E spending at rate of 3 percent.
- Table 12 represents start-up firms that maintain a constant R & E spending level.
- Table 13 represents start-up firms that decrease their R & E spending at a rate of 1 percent annually.
- Table 14 represents start-up firms that decrease their R & E spending at a rate of 3 percent annually.
- Table 15 represents start-up firms with mildly cyclical R & E spending patterns.

- Tables 16 represents start-up firms with highly cyclical R & E spending patterns.

Notes

On all tables, R & E spending is given in thousands of dollars. The column labeled "Credit $ Current Law" displays the tax credit which will result from current law for the indicated year and R & E spending level. The column labeled "Base Primary GNP = 2.5%" displays the "base" as calculated under S.570 and H.R. 1416 for hypothetical firms electing the "primary credit", taking into consideration the firm's historical R & E spending levels.

The column labeled "Credit $ Primary 20% indicates the tax credit that would result from the base calculation under the bill as determined above. The column labeled "Credit $ Secondary 7% + 75% of Base" indicates the tax credit that would result from electing the "alternative credit calculation" described in S. 570 and H.R. 1416. "Maximum Credit $ Available" calculates the firm's optimal return from the new credit, assuming the firm switches between the primary and secondary credit at the most propitious time taking into account the 3 year irrevocable election.

The amount designated as "Total Credit" at the bottom of each Table indicates the combined total credit amounts for the particular spending pattern under both current law and the proposed legislation, for the years 1990 through 1994 (established firms) and 1990-1997 (start-up firms). It is used as a rough gauge or a scoreboard of the relative advantages of on system over another.

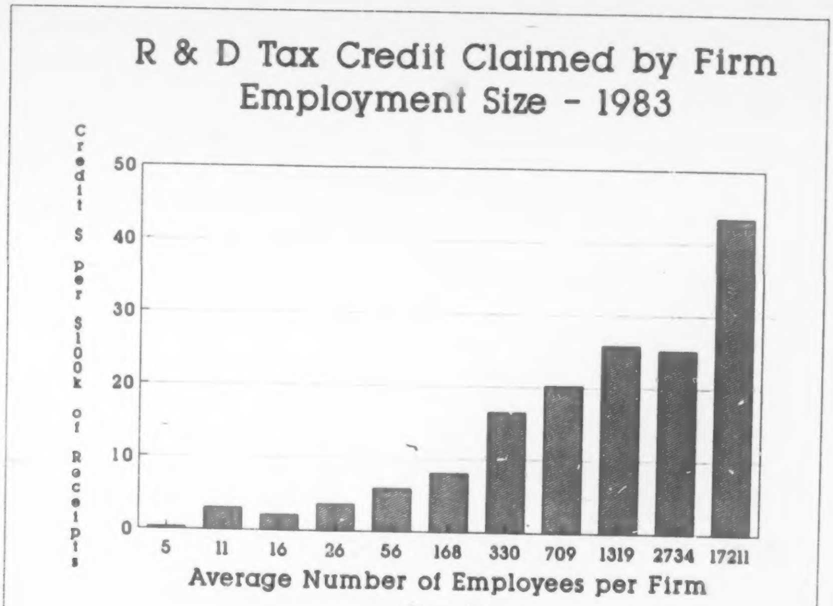
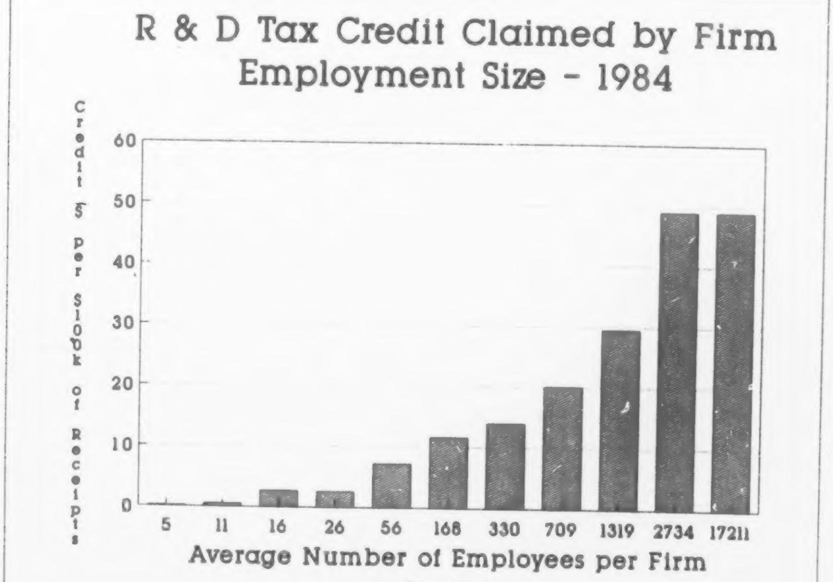


Chart # 1



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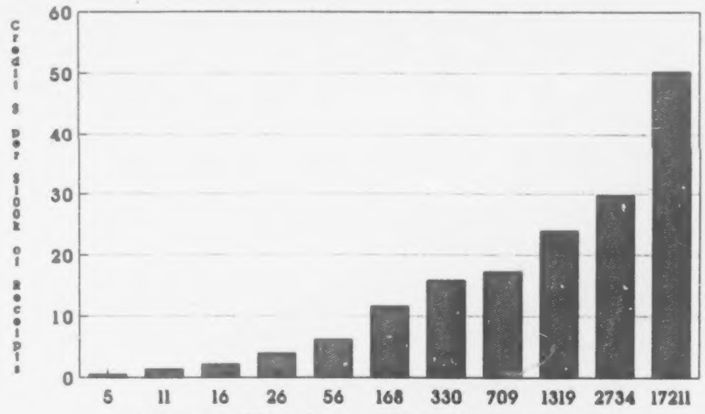

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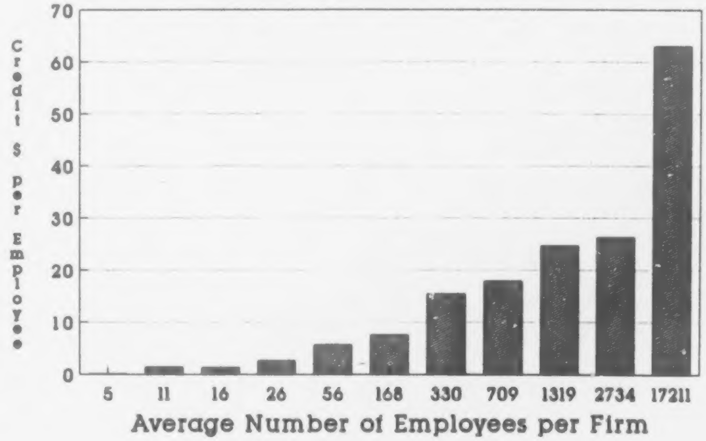


Chart # 4

R & D Tax Credit Claimed by Firm Employment Size - 1984

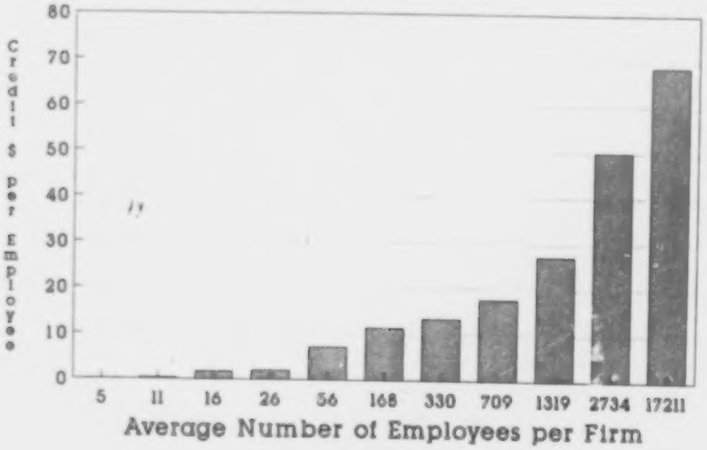
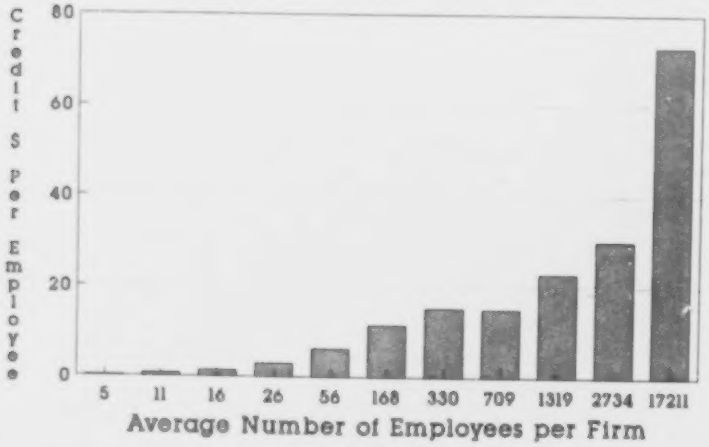


Chart # 5

R & D Tax Credit Claimed by Firm Employment Size - 1985



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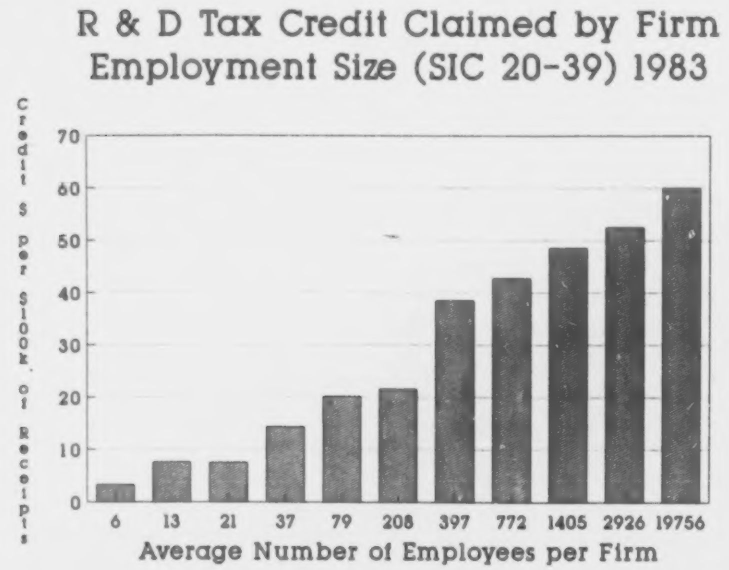


Chart # 7

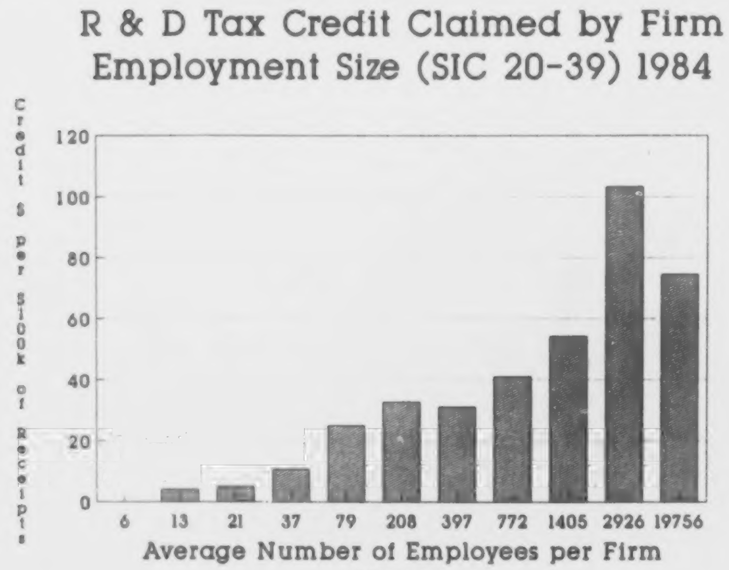
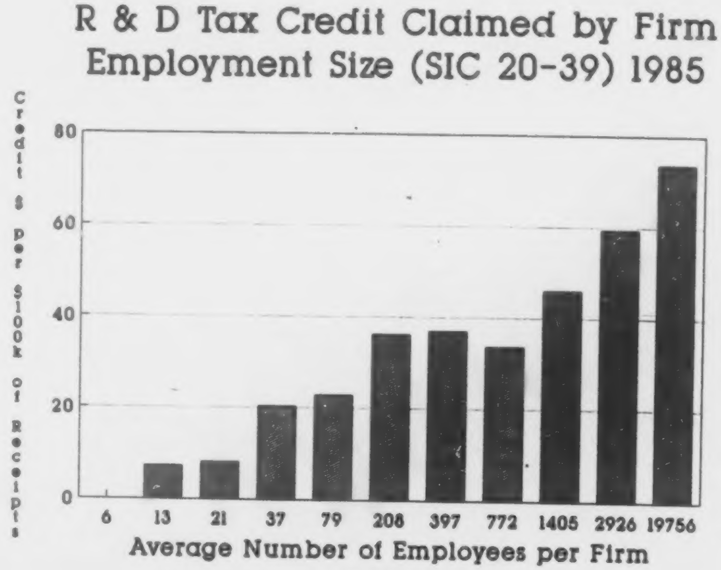
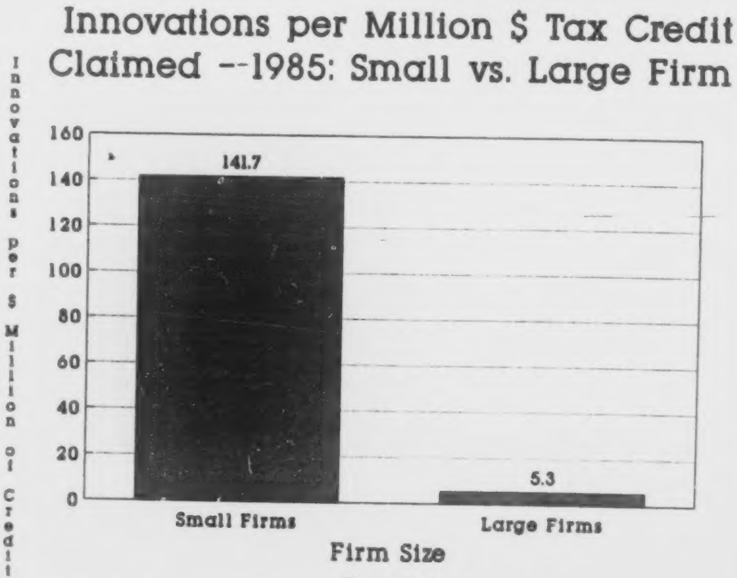


Chart # 8



R & D Tax Credit Claimed by Firm Employment Size (SIC 20-39) 1985

Chart # 9



Innovations per Million $ Tax Credit Claimed --1985: Small vs. Large Firm

Chart # 10

D. Nelson Adams
One Chase Manhattan Plaza
New York, New York 10005

Statement on the Taxation of Capital Gains for the Consideration of the Chairman of the Ways and Means Committee and the Subcommittee on Select Revenue Measures

The Administration has proposed reducing the capital gains tax rate to 15%. The reasons given (Statement of the Assistant Secretary of the Treasury, Dennis E. Ross, to the Senate Finance Committee on March 14) are to encourage long-term investment, to free taxpayers to make investment decisions based on economic considerations, and to make our tax policy compatible with our major trading partners, Canada, Japan, Germany and the U.K. In addition, the Administration points out the unfairness of taxing gains that result from inflation, but believes that it would be too complicated to correct this and, therefore, concludes that it would be preferable simply to tax gains at an arbitrary but lower rate that will in an approximate way take all the factors into account.

The proposal has encountered a storm of opposition, primarily because a lower rate of tax is viewed as unfairly discriminating in favor of the wealthy. From a political standpoint, it is hard sailing against this wind.

A solution which might be more acceptable to members of Congress and which would address the problem in a more direct and understandable way would be to continue to tax capital gains at ordinary income tax rates but to determine taxable gain by excluding appreciation which results solely from inflation. I do not believe this would introduce undue complexity. Only a simple table (simpler than current depreciation schedules) would be needed to adjust the cost of a capital asset by the yearly changes in the CPI. This would solve the principal problem which has been inherent in the capital gains tax ever since inflation became a matter of serious concern in the U.S. economy. It would also serve indirectly to accomplish some if not all of the other objectives advanced by the Administration in recommending a lower tax rate.

If necessary to ensure acceptance of this proposal, it could be coupled with a trade off which seems eminently fair. Consideration should be given to eliminating the stepped up basis (i. e., the value at the time of death) that assets now receive on death, which has been proposed without success in the past. When the asset is sold, the estate or the legatees would have to pay tax on the gain realized in excess of the decedent's cost, adjusted for inflation as proposed above. The basis would be increased by the portion of any estate tax attributable to the net appreciation in the value of the asset. This would make transfers at death consistent with the present policy of taxing transfers by gift.

There are those, however, who see nothing unfair in taxing profits resulting solely from inflation. Their reasoning appears to be, first, it is the wealthy who have capital gains and, second, many taxpayers borrow to purchase capital assets and benefit by paying off their loans in cheaper dollars.

As the above noted Statement to the Senate Finance Committee points out, it is not only the wealthy who pay capital gains taxes. In 1985, the latest year for which tax return data has been analyzed, one-third of all tax returns with long-term capital gains had other income of less than $20,000, nearly three-fourths of all tax returns with capital gains had other income of less than $50,000; and less than 2 per cent had other income of $200,000 or more.

The principal argument on the issue of fairness, however, seems to be that many purchasers of property borrow to finance their purchase and have no reason to complain because the tax they pay due to inflation is offset by the benefit they derive from paying off the loan with cheaper dollars. This is not necessarily so.

Inflation, of course, affects the economic result of borrowing as well as lending money. For that matter, it affects all transactions calling for the payment of dollars in the future, such as long term leases and deferred compensation. This is why borrowers and lenders in agreeing on the rate of interest normally include what they believe is necessary to compensate for inflation over the term of the loan. They may overestimate or underestimate the actual rate of inflation to the advantage or disadvantage of borrower or lender but that is just part of the deal they have struck. The Internal Revenue Code is not called upon to intervene as a third party to the transaction. A purchaser of property who finances his purchase by borrowing pays a higher rate of interest to compensate for inflation and thus has not obtained an offsetting benefit.

It has also been pointed out, not without some justification, that some holders of property benefit through the appreciation in their property year by year without having to pay any tax until the property is sold. This is true to the extent that the appreciation actually is in excess of inflation. It results from the fundamental policy of our tax law that neither gains nor losses are given effect until realized. This policy benefits some holders of property while penalizing others. It involves entirely different considerations. Whether it is fair or not, it does not provide sufficient justification for taxing inflation.

The Internal Revenue Code cannot be expected to cure all the woes brought on by inflation. It can and clearly should, however, stop taxing "gains" that represent no more than the loss in purchasing power of the dollar. While this has been true for many years, it has become particularly unjust when the rate of tax has been increased from 20% to 28%. It is quite possibly this factor more than any other that has sent the individual investor to the sidelines.

D. Nelson Adams

New York, May 18, 1989

The writer is a former Chairman of the Tax Committee of the Association of the Bar of the City of New York.

American Tree Farm System

Please reply to:
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1987 National Outstanding Tree Farmers
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(912) 336-8973

May 5, 1989

The Honorable Dan Rostenkowski
2111 Rayburn House Office Building
Independence & South Capitol Streets SE
Washington, DC 20515

Dear Congressman Rostenkowski:

I appreciate the opportunity to submit a written statement regarding revenue proposals in the President's budget.

I urge that income from timber be reinstated for capital gains treatment to correct problems created by the 1986 Tax Reform Bill. The new tax treatments and tax rules for tree farmers are a nightmare. More and more taxpayers are having to have their income tax forms prepared by professionals who are charging more to do it because of the complexity of this so-called simplified tax reform law.

The IRS is complicating this mess further by the "passive loss" rules. I understand that the intent is to prevent people from taking deductions for a summer place where they grow a few trees as a hobby, but requiring that each landowner show 100 or more hours of work on their Tree Farm each year in order to be able to deduct expenses is ridiculous. I spend plenty of time on my Tree Farm because I live there, but my children live far away from the farm. I plan for them to carry on the Tree Farm work after I'm gone, but they will have to use help to get the work done and make decisions from a distance. There are a lot of people like this who live at a distance from their land. And a lot of people whose land is not in a phase that requires 100 hours or more of work in a year.

We're not running hamburger stands where we go to work every day, we're growing trees over many years. The tax folks don't understand this at all.

The research firm of Arthur D. Little reports that it will take more that five billion hours to prepare the 1988 tax forms where it took only 4.3 billion hours to prepare the 1983 tax forms. The IRS has maintained that it took only 631 million hours, but they did not count in the record keeping that one has to do to be able to prepare this tax form or present it to one who prepares income tax forms for the public. A monstrosity has been created.

In 1987 I had a CPA do a computer projection of my taxes under the new rules. The printout showed what my income tax for 1986 would be, and also projected the 1987 and 1988 tax that I would owe under that new law using the same income that I showed for 1986.

TREE FARM
THE SIGN OF GOOD FORESTRY

In doing this projection, he ran my 1986 income and deductions through his computer using the 1987 and 1988 tax changes. To my dismay, my 1987 taxes went up 57 percent over 1986, and my 1988 taxes up 71 percent over 1986 using the same income and deductions that I reported on my income tax return for 1986. The return took four pages for 1986 and nine pages for 1987 and 1988 -- an increase of over 100 percent in paperwork for the new law. The main reasons for the increase are loss of capital gains. I understand that timber growing has been linked with other abusive tax shelters that Congress was trying to do away with. This is naive thinking. In South Georgia, it takes 13 years after a seedling is set before you can get any kind of return, and then only if you are lucky and thinnings don't cost more than they bring to harvest them. If you are growing saw timber, you are looking at 30 to 45 years with thinnings now and then that might cover some expense incurred along the way. If growing pulpwood, you would harvest in about 20 years with a lot less earnings for your labor.

It is my belief that Congress has to take another look at the timber situation in regards to capital gains. Perhaps there could be a waiting period of five to seven years after the purchase of timberland before it would be eligible for capital gains. If raising timber, it would be at least 13 to 15 years before any kind of harvest. With so long a waiting period, it should automatically qualify for capital gains treatment or be totally exempt from any kind of tax.

With no tax incentives, the only way that trees will get planted will be through government programs such as the Conservation Reserve Program (CRP). Don't get me wrong, I am an ardent supporter of CRP, but only so far as it pertains to taking highly erodible or marginal land out of production and planting a better crop -- trees. The incentive for planting trees needs to be in producing the product for its own profitability, not for government payments.

When we lose forestland, we lose a major natural resource that provides an essential raw material for wood and paper products. But forests serve us in many other ways, too. Tree Farms like mine provide important habitat for game and other wildlife. Hunters and campers know all about the value of healthy, growing forests for a variety of recreational uses. Without forests, our world would be a grayer place for all of us.

In conclusion, let's take a look at how other industrialized nations tax capital gains. The maximum long-term capital gains tax rate in the United States is 33 percent, United Kingdom 30 percent, Sweden 18 percent, Canada 17.51 percent, France 16 percent, West Germany - exempt, Belgium - exempt, Italy - exempt, Japan - exempt, Netherlands - exempt, Hong Kong - exempt, Singapore - exempt, South Korea - exempt, Taiwan - exempt, Malaysia - exempt. Some of the fastest growing nations do not tax capital gains at all. This should tell us something.

Thank you,

C. M. Stripling

C. M. Stripling

The American Waterways Operators, Inc.

Executive Offices

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Arlington, VA 22209

Tel 703 841-9300

April 11, 1989

Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The American Waterways Operators (AWO) wishes to submit comments for the record in connection with your hearings on proposals contained in President Bush's Fiscal Year 1990 budget. Our comments focus on miscellaneous user fees affecting revenue collections.

AWO is the national trade association of the inland and coastal barge and towing industry. AWO member companies operate towboats, tugboats and barges on the East, West and Gulf Coasts, and on the inland waterway system. Over one half of the onboard jobs in the U.S. Merchant Marine have been created by the towing industry. 87 percent of all U.S. cities are served by tug-barge moves. Almost 60 percent of all grain exported by the United States is moved to seaports in barges, and one of every five tons of coal produced in the nation is carried by barge. Barge transportation accounts for 40 percent of U.S. petroleum movements. Our vessels transport about fifteen percent of the nation's intercity freight for just two percent of the total freight bill.

The user fees contained in the FY 90 budget are a form of taxation, no matter how one would attempt to cloak them. $180 million in Coast Guard user fees has been proposed in the FY 90 budget. Since 1981, Congress has consistently rejected the concept of Coast Guard user fees. The "services" provided by the Coast Guard are Congressionally-mandated regulations with which our industry is legally bound to comply with; fees for such services are no more than thinly disguised taxes.

Fierce competition is the chief hallmark of the tug and barge industry which produces a bounty for American shippers and consumers: quality service, innovation and, most of all, low prices. This competition keeps margins razor thin in the best of times. The line between survival and bankruptcy is often narrow for barging companies. In other words, anything which affects that thin margin threatens the existence of domestic water carriers. And, the imposition of user fees takes dead aim at the towing industry.

Each year, since 1981, Congress has rejected attempts to establish a system of Coast Guard user fees for commercial vessels. These attempts have failed because they are motivated by budgetary considerations and take aim at an already burdened industry. The U.S.-flag merchant marine is just emerging from an unprecedented economic depression. Coast Guard user fees will not magically solve the agency's budget or manpower deficiencies, but will greatly impede the ability of the U.S. maritime industry to regain economic viability.

The Bush Administration's FY 90 budget proposes the imposition of $180 million in user fees for Coast Guard services. Services performed by the Coast Guard result from statutorily-mandated requirements which have been given by Congress to the Coast Guard. Thus, the agency performs a governmental function and has promulgated rules and regulations with which the industry must comply. A true user fee would involve either an optional service that the user could accept or reject, or a service specifically requested by an identifiable beneficiary. The proposed user fees in the Administration's budget, because the services they would nominally finance cannot be rejected, are not user fees at all - they are new taxes on the U.S. maritime industry.

As this committee should surely know, domestic water carriers have been paying a bundle of federal user fees since 1980. The inland waterway user tax will double by 1995 under the Water Resources Development Act of 1986, P.L. 99-662. Port user fees were also established under this Act. The harbor maintenance fee established in P.L. 99-662 imposes a new tax on cargo transported by water; it will raise approximately $150 million per year. Our industry now pays a tax for cleanup of leaking underground storage tanks. Additionally, many vessel operators are paying user fees to the U.S. Customs Service for paperwork processing. Most of these federal user fees, payable in addition to the general tax liability imposed by the federal government on American business, apply only to water carriers or only to waterborne cargo. The tug and barge industry competes for freight transport with railroads, pipelines and, to a lesser extent, trucks, and with each new layer of fees, finds it more difficult to compete.

Individual sectors of industrial and agricultural economies should not be viewed as revenue sources over and above what they are already paying in taxes. Yet, user taxes are more and more sought simply as revenue raisers. The so-called "beneficiaries" are narrowly defined, so each user tax is imposed on relatively few citizens and real debate, pro and con, is foreclosed. That defies a tenet of a democratic society. The result is that only the victims see the tax. In such a manner, certain sectors of the society are picked off one at a time.

Sincerely,

Joe Farrell

Joseph Farrell

STATEMENT OF

THE
FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

THE
NATIONAL FOREST PRODUCTS ASSOCIATION

AND

ALABAMA FORESTRY ASSOCIATION

ALASKA LOGGERS ASSOCIATION

AMERICAN FOREST COUNCIL

AMERICAN FORESTRY ASSOCIATION

AMERICAN PULPWOOD ASSOCIATION

ARKANSAS FORESTRY ASSOCIATION

ASSOC. OF CONSULTING FORESTERS

ASSOCIATED OREGON INDUSTRIES

FLORIDA FORESTRY ASSOCIATION

FOREST FARMERS ASSOCIATION

GEORGIA FORESTRY ASSOCIATION

INTERMOUNTAIN (ID) FOREST INDUSTRY ASSOCIATION

ILLINOIS WOODLAND OWNERS ASSOCIATION

KENTUCKY FOREST INDUSTRIES ASSOCIATION

LOUISIANA FORESTRY ASSOCIATION

LUMBER MANUFACTURERS ASSOCIATION OF VIRGINIA

MAINE FOREST PRODUCTS COUNCIL

MARYLAND FORESTRY ASSOCIATION

MICHIGAN FORESTRY ASSOCIATION

MICHIGAN-WISCONSIN TIMBER PRODUCERS ASSOCIATION

MINNESOTA FORESTRY ASSOCIATION

MISSISSIPPI FORESTRY ASSOCIATION

MISSOURI FOREST PRODUCTS ASSOCIATION

NATIONAL CHRISTMAS TREE ASSOCIATION

NEW JERSEY FORESTRY ASSOCIATION

NEW HAMPSHIRE TIMBERLAND OWNERS ASSOCIATION

NORTH CAROLINA FORESTRY ASSOCIATION

OHIO FORESTRY ASSOCIATION

OKLAHOMA FORESTRY ASSOCIATION

OREGON SMALL WOODLAND OWNERS ASSN.

PENNSYLVANIA FORESTRY ASSOCIATION

SOUTH CAROLINA FORESTRY ASSOCIATION

SOUTHERN FOREST PRODUCTS ASSOCIATION

TENNESSEE FORESTRY ASSOCIATION

TEXAS FORESTRY ASSOCIATION

TIMBER ASSOCIATION OF CALIFORNIA

VIRGINIA FORESTRY ASSOCIATION

WASHINGTON FARM FORESTRY ASSOCIATION

WEST VIRGINIA FORESTRY ASSOCIATION

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

HEARING ON

THE CAPITAL GAINS PROPOSAL

CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

APRIL 13, 1989

The Forest Industries Committee on Timber Valuation and Taxation, and the National Forest Products Association, appreciates the opportunity to present this statement to the Ways and Means Committee for their consideration during deliberations on the capital gains rate reduction proposal contained in President Bush's Fiscal Year 1990 Budget. Capital gains has been an extremely important provision to timber growers since 1944, and its repeal in 1986 was a devastating blow to an already economically fragile resource. In that regard, we are greatly encouraged by the capital gains initiative of President Bush, and support an active consideration of his proposal in this Committee as the much-needed first step in the process to restore tax equity and fairness to timber growers.

However, significant modifications to President Bush's proposal are critically necessary regarding its application to timber and forms of ownership. The proposal does not include timber (with the exception of so-called "investment timber" and land), and does not include corporations. Both of these deficiencies need to be corrected in order to provide equity and fairness to the proposal.

The Forest Industries Committee on Timber Valuation and Taxation is a long-established national organization of thousands of landowners and Tree Farmers, whose members are geographically dispersed throughout the United States, and range in size from the largest, most fully integrated manufacturing companies, to the smallest individual private Tree Farmer, all of whom are keenly interested in the taxation of timber. The National Forest Products Association is also a long-established national trade association which represents the interests and views of all producers of hardwood and softwood forest products, and affiliated regional and product associations.

The two organizations are submitting this statement jointly as a demonstration of the interrelationship and interdependence of timber growers and landowners as the raw material source to the mills and production facilities of the thousands of wood products manufacturers throughout the United States. Our interdependence as "supplier and market" provides a common interest in the equitable taxation of timber. In a like manner, there are a number of other associations and organizations related to timber growing who would also like to be associated with this statement. A partial but representative list of those organizations is included on the cover of this statement. As Committee members can see from the list, the interest in fair timber taxation is both broad and deep, with a geographic diversity across America.

President Bush's Proposal for a Capital Gains Rate Reduction

President Bush's budget proposals for fiscal year 1990 contains a provision calling for a restoration of a capital gains tax differential, to help stimulate greater saving, and investment. These are laudatory goals which we strongly support. In that regard, we are greatly encouraged by President Bush's capital gains proposal as a much-needed recognition at the highest level of government of the key role played by capital gains in achieving those goals. We believe President Bush should be commended for his initiative as a sound first step in the process of reestablishing a critical component to equitable taxation. Although there are extremely important modifications needed in its application to timber and forms of ownership which we will discuss later, President Bush's initiative is a vital sign to America that his Administration is committed to working toward a healthy economic environment supportive of increased saving and investment.

Additionally, we are pleased to see the U.S. Treasury figures showing capital gains to be a revenue raiser for the government, not only an economic stimulant. In these days of troublesome federal budget deficits, the Administration's recognition of the increased revenue effect of capital gains will go a long way toward helping to ease that deficit. Treasury's use of dynamic rather than static estimates correctly recognizes the affects of taxpayer response, a critical factor when the realization decision is entirely within the taxpayer's control. It should also be noted that the lower rates established in the Tax Reform Act of 1986 for both individuals and corporations were significantly beneficial. The continuation of these rates at their present levels is clearly important to the nation's economic health.

President Bush's proposal also shifts the business focus from short run to long range, reduces the cost of capital, enhances productivity, and helps increase U.S. competitiveness. The proposal also reduces the Tax Code's bias toward debt financing by decreasing the cost of equity capital. Finally, the proposal reduces taxation of inflationary gains by utilizing a tax rate differential rather than the more complex index adjustment to cost basis. The Treasury analysis indicates that increased tax revenue from capital asset realizations exceed the potential loss of revenue due to rate reduction in every fiscal year from 1989 to 1999. The President's proposal for a 100% exclusion of capital gain for taxpayers with adjusted gross incomes below $20,000 is a welcome initiative, and perhaps recognizes that our major international competitors either tax capital gains lightly, or not at all.

Other areas of favorable benefit of the President's proposal should also be noted. While the proposed holding period extension can possibly create undesirable "cliff effects," it is preferable to the alternative of reduced tax rates tied to length of holding period. The latter approach would add both "cliffs" and complexity to the Code. Importantly, the 15% cap is a necessary and vital element of the proposal, since it provides the taxpayer with absolute assurance that the tax rate on his realization will be no higher; under our complex Tax Code currently, the marginal tax rates on capital gains realization can exceed 50% if IRA, medical deduction limitations, or social security "taxation" are considered. Additionally, the use of a "cap" in concert with an exclusion has historical precedence in the "alternative capital gains" tax system which existed prior to 1970.

While the Administration's "overview" document indicates that both the "exclusion" and the "maximum tax rate" (15%) will apply to the alternative minimum tax, there is no indication in the detailed General Explanation that the exclusion applies in the alternative minimum tax calculation. It appears that the intent was to provide a corollary minimum tax cap of 15%, as opposed to the normal alternative minimum tax rate of 21%. A 15% cap in the alternative minimum tax calculation is entirely appropriate, since the intent of this legislation is to establish a reduced rate of tax on capital gains generally. It is important, however, to incorporate capital gains in the alternative minimum tax process only via an alternative capital gains calculation. In the pre-Tax Reform Act of 1986 calculation, even though capital gains alternative minimum taxes were limited to 20%, inclusion of capital gains in the alternative minimum tax base triggered alternative minimum taxes on other tax preference items, resulting in capital gains realizations being effectively taxed at marginal rates above 20%.

These are positive attributes of the President's proposal. However, the omission of corporate capital gains, and most trade or business capital assets is puzzling. These omissions flaw President Bush's initiative.

Shortcomings in the President's Proposal

The President's proposal would permit a capital gains rate differential on a selective basis only, restoring capital gains for individuals, while ignoring corporations, and limiting the preferential treatment to a new concept of "investment asset", while disallowing it for assets used in a trade or business (with the exception of land). The selective basis of his proposal is especially curious when one views the goals it hopes to achieve.

Distinctions Between Forms of Ownership

The Administration's proposal to reduce the capital gains tax rate to 15% contains numerous positive attributes, but the glaring omission of corporate capital gains is particularly puzzling. While capital gains of individuals, REITS, RICs, partnerships, and similar "pass-through" entities are included, equivalent capital gains by regular corporations are omitted without any justifying rationale for their exclusion. Equity, as well as sound tax policy, dictates that similar assets should be taxed essentially the same, irrespective of the form of underlying ownership.

A fundamental tenet of tax policy is that the form of ownership should not materially impact the marginal rate of taxation applied to a transaction. Admittedly, double taxation of corporate earnings continues to violate this basic principle. Such violations lead to inequities and excessive "tax planning" to compensate for these distortions. By way of example, the Tax Reform Act of 1986 established a 34% - 28% maximum tax rate differential between corporations and individuals, representing the first time in history that the corporate tax rate has exceeded the individual rate. Not surprisingly, Treasury's 1988 preliminary statistics indicate that while business returns in total are expected to increase by 5.2%, regular corporate returns will decrease by 2.4% (unprecedented in recent history). Conversely, individual and pass-through entity business returns are projected to increase by 6.4%.

Additionally, under current law, an individual is taxed at a 28% rate on an asset owned directly, but at a 52.5% (a 1.9 times tax multiplier effect) on the same profit realized by a corporation and paid to the taxpayer as a dividend. If there is no comparable reduction in corporate capital gains, an individual will incur 3.5 times more tax on a corporate asset than on the same asset owned directly. This illogical and unwarranted expansion of the existing tax inequity, based solely on the form of doing business, is insupportable and will unnecessarily further encourage the restructuring of asset ownership.

Internal Consistency Issues

The proposal's cornerstone, taxpayer responsiveness to lower tax rates (the "unlocking effect"), fulfills two basic functions. First, the "unlocking effect" significantly increases tax revenues in the early years, offsetting the revenues lost from a shift to a 3 year holding period. Secondly, the enhanced liquidity of the nation's capital stock provides additional stimulus for increased economic growth over the longer term. These benefits to the economy are equally appropriate for the corporate sector. Corporate "unlocking" would stimulate economic growth, providing incremental tax revenue over both the short and long term.

The basic objectives of the proposal are to stimulate long-term economic growth, create jobs, and enhance our international competitiveness relative to major industrialized nations. For those objectives to be achieved, a revitalization of the nation's basic productive capacity is required. This means that corporate America should rightly be included in the current proposal. In addition, the gain on sale or exchange of "assets used in a trade or business" should be treated as "capital assets" qualifying for the capital gains rate differential.

One of the objectives of the proposal is to encourage a flow of capital to innovative, technologically advanced and entrepreneurial-type activities. The omission of corporations ignores the substantial amounts of venture capital funds that currently and historically have come from financial and regular corporations taking equity positions in new ventures. Excluding corporations is inconsistent with that objective.

The proposal notes that restoration of a rate differential roughly corrects for taxation of fictitious, inflationary gains without creating the complexities that indexing of basis would entail. Corporations, likewise, are taxed on fictional gains resulting from inflation under our current system. Continuation of the taxation of "phantom" corporate gains is discriminatory.

Corporations may have been excluded because of a presumed lack of corporate-sector responsiveness to reduced capital gains rates. Exclusion based on this assumption may not be correct. Corporations, historically, have never been exposed to changes in capital gains rates of sufficient magnitude to support this conclusion. The minor one- to three-percentage point rate changes which have previously occurred have always been inadequate to support empirical studies on corporate capital gains responsiveness. Assuming a common definition of "capital assets" and comparable rate reductions for both corporations and individuals, corporate capital gain responsiveness could equal or exceed that of individuals.

Treatment of "Business Assets" in the President's Proposal

The Administration proposes to restore capital gains benefits for individuals, but essentially limits such treatment to "investment assets". To enhance the nation's productive capacity and our competitive ability, as well as to provide simple equity, the proposal should be expanded to include all Section 1231 assets.

The effect of President Bush's proposal is to establish a new category of assets, i.e., "investment assets" vs. "business assets" for the first time in the history of the Tax Code. The new distinction obliterates the existing differentiation between "assets used in a trade or business" (plant, machinery, etc.) and "assets held primarily for sale by a trade or business" (inventory, etc.). This results in a capital gains treatment of an investment being differentiated on the basis of whether it was in paper (a stock certificate) or in physical assets (machinery and equipment). Neither in tax policy nor in economic basis is there any justification for such a distinction.

Treasury provides a series of "justifications" for the exclusion of Section 1231 assets, and perhaps the simplest method of clarification is to address each one of these assertions in order:

1. "Business income, whether derived from the sale of property used in a trade or business or from the sale of property to customers in the ordinary course of business, should be taxed as ordinary income."

    - Throughout the Treasury analysis, an attempt is made to establish a distinction which has not previously existed -- one between "business assets" and "investment assets."

The reason for the absence in the legislative history of such an artificial distinction should be obvious. If Investor A purchases $1,000 in stock, and the $1,000 is utilized to acquire machinery and equipment, and Investor B purchases $1,000 of M&E directly, what logic would support a differential tax treatment upon a disposition by either Investor A or Investor B?

- As stated in the 1985 Treasury report,[1] "The theme running through the exceptions is that capital gain treatment is appropriate only for income resulting from the appreciation in value of investment property or property used in a trade or business. Thus, there are exceptions that deny capital gain treatment of income from . . . the ordinary profits of business operations." Accordingly, the appropriate distinction is between "income from sales in the ordinary course . . ." and "income from appreciation" rather than between "investment assets" and "business assets."

2. "The asymmetrical treatment of Section 1231 gains and losses is without justification in tax policy."

   - This assertion ignores both history and the oft-stated rationale for the apparent "asymmetry." The treatment of net gains on Section 1231 property as "capital" and net losses as "ordinary" was sanctioned by the 1942 Act, which restored the capital asset status temporarily taken from these assets by the 1938 Act. Clearly the intent of Congress was to provide a superior tax treatment for "assets used in the trade or business" in anticipation that the business community would replace its antiquated production resources with more modern facilities and equipment.

     One can surmise that such treatment remains amply justified since Congress has reviewed this treatment on numerous occasions, and, in fact, left it intact until the TRA of 1984 -- a period of some 42 years. And the 1984 modification was simply a restraint, not a repeal, imposed to thwart a limited number of taxpayers who were "gaming the system" by taking capital gains in one year and capital losses in another.

   - A critical element in U.S. industry's prospects for meeting the challenge in the international market place is its ability to modernize plant and equipment. Assuming that is still a national objective, the Tax Code should support, not hinder, such modernization.

3. "The availability of capital gains treatment for gains from sales of depreciable assets stems from implementation of excess profits taxes during World War II."

   - Factually, capital gains treatment for "assets used in the trade or business," including depreciable property, has been available since a special tax rate for capital gains became part of the Tax Code in 1922. The singular exception (not counting post-1987, of course), was the period 1939 through 1942, when "Section 1231" assets were treated as "ordinary" in order to provide a better tax benefit. Because Section 1231 assets were generally being disposed of at a loss during the depression years -- and the deductibility of capital losses was severely limited -- Congress in the 1938 Act simply shifted Section 1231 assets to the "ordinary income" category so that the capital losses could attain a full tax writeoff. By 1942, the wartime economy, coupled with government requisitions, was generating gains on Section 1231 assets, and it became appropriate to restore them to their historical capital asset status. Treasury's explanation was unfortunately taken totally out of historical context.

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[1] Secretary of the Treasury. 1985. Report to Congress on the Capital Gains Tax Reductions of 1978. Office of Tax Analysis, U.S. Government Printing Office, Washington, D.C.

4. "One of the significant policy advantages of current law is the greatly reduced significance of recapture rules."

   - The "recapture rules" of sections 1245 and 1250 have been a key element of the Code, largely preventing the conversion of ordinary income to capital gains as a function of depreciation write-offs. They did not, however, "go away" with the enactment of the '86 Act. Rather, all of the calculations under the "recapture rules" are still necessary in order to separate capital gains or losses from ordinary profits. Recapture may have "greatly reduced significance" simply because of the current absence of a capital gains benefit, but all of the calculations and administrative effort are still in place.

   - Under Section 1245, all depreciation previously claimed is "recaptured," so the only potential for capital gains on depreciable personal (Section 1245) property would occur when the sales price exceeds the original cost. While an admittedly rare circumstance, such an instance clearly represents a true capital gain, and its not clear why Treasury chose to exclude such gains from beneficial treatment.

5. "Restoration of a capital gain preference for depreciable and depletable business property would make tax shelter investments more attractive."

   - Advocates of capital gains restoration have no interest in reinstituting "tax shelters," but it is not apparent why including Section 1231 assets in the capital gains restoration would produce that result. As noted above, depreciation is fully recaptured on Section 1245 personal property, thus no "tax shelter" potential exists.

   - In the case of real property subject to Section 1250, depreciation is only partially recaptured so there is some measure of prospective "conversion" of ordinary income to capital gains over the life of a real property asset. If "tax shelters" remain a concern, even with the existence of the "passive loss rules" and extended depreciable lives, then the expansion of Section 1250 to encompass Section 1245-type limits on depreciable structures should solve that problem.

6. "Gains on non-depreciable property that is used in a trade or business and is not held for sale in the ordinary course of business would be eligible for lower capital gains rates. Loss would also be treated as capital losses."

   - In an abrupt reversal of all logic which has preceded this particular language, Treasury decides, and correctly so, that its attempted bifurcation of capital assets between "investment assets" and "business assets" is inappropriate. And so for "non-depreciable business assets," it would permit capital gain treatment. One can only applaud the correctness of this posture on non-depreciables and urge its extension to "depreciable property."

Treatment of Timber as a Section 1231 Asset

Gains or loss realized on timber dispositions should continue to be treated as a Section 1231 asset. Treasury maintains that the special treatment provided under Section 1231 applies to "assets held for sale in the ordinary course of business". It is true that timber sold pursuant to Section 631(b) qualifies as a Section 1231 asset, if the seller retains an economic interest. But that does not apply to timber under a Section 631(a) election where the owner who cuts his timber for his own use is deemed under the election to have made a sale. If timber were excluded from Section 1231 treatment, it would mean that the inequity which existed prior to 1944 would return. Under the pre-1944 situation, taxpayers selling land with the timber could qualify for capital gains treatment, while taxpayers who sold only the timber, or those who cut timber for their own use, would have to report all the gain as ordinary income. Congress qualified all timber sales in the Revenue Act of 1943 when it determined the bifurcated tax treatment resulted in inequitable treatment of timber owners and led in some cases to timber cutting practices which were depleting the nation's critical resource of timber.

That decision of Congress proved to be wise. From 1944 on, the number of trees planted has far exceed those cut each year and long-term timber management has increased. The nation's timber inventory has increased, notwithstanding that demand for timber products substantially increased over the same period.

Other Components of Timber

A timber operation requires heavy front-end expenditures, long-term carrying charges, high risks of weather, disease, insects, and fire -- all uninsurable. Of course, there is the market risk of waiting decades until the trees are ready for harvest. Without a rate differential, timber is unlikely to attract sufficient investment capital to keep up with the increasing demand. Those who would respond by saying that if demand exceeds supply it will drive up prices bringing capital back to the timber industry have not fully considered the uniqueness of timber growing. For every year that there is inadequate reforestation and ineffective timber management, the more planting that has to be done in the future to makeup for this loss. Already in the northwest region of the country there are disturbing signs of timber shortages. Many sawmills have shut down because they cannot obtain logs. More are likely to be closed from the pressure resulting from forestland being taken out of production for a variety of reasons. This means that those lands remaining for timber production must be managed more intensively. To the extent that private-forest landowners do not reforest, or management practices become less efficient due to misdirected tax policy, those pressures will continue to escalate the pressure on public lands.

Unless equitable tax treatment is restored for timber growing, it will curtail investment and timber growth and jobs will be lost. Thus, revenues will be reduced. Investment in timber is not a tax shelter and capital gains has been accorded to create an equity between investors in timber and those who invest in other kinds of businesses. The equitable tax treatment of timber reversed the pre-1944 trend of cutting without any follow through with timber planting and good timber management.

Timber growers responded to the equitable tax treatment that Congress provided commencing in 1944, and the results have been spectacular. Thousands of farmers have invested untold funds, time and effort in growing trees. In 1986, the rug was pulled out for many timber growers because the equitable tax treatment they expected to get when they sold their timber was revoked, forcing them to report gains when they sell their timber at ordinary rates and without the possibility of averaging their income even though economic circumstances forces them to receive a lifetime's gain on their timber in one year.

The repeal of capital gains rates by the '86 Act created a serious inequity for all risk takers and for those who invest in the productive sector of the economy. There is a dispute over whether capital gains rates result in a revenue loss or a revenue gain. Regardless of whose revenue estimates are valid, the true measure is how much additional revenue is raised from a stimulated economy when the risk takers believe they are taxed fairly on the gain, if any, that is realized on such investments. The repeal of capital gains has created a disastrous situation for the forest industry. The long period of time that trees must be nurtured before they are ready for harvest exacerbates the inequity. Because trees are held so much longer than other productive assets a larger part of the nominal gain is inflationary or imaginary gain. To tax the nominal gain at ordinary rates results in an effective tax on the economic gain far in excess of the statutory rate. Lack of a capital gains rate differential results in the taxation of timber sales gains at excessively high rates. For example, if a tree farmer had to hold his trees for 25 years (a not unusual holding period, in fact, it is on the low side) and during that period the nation experienced an annual rate of inflation of 4%, at least half the gain would be inflationary or phantom gain. If the tree farmer is taxed at 28% on the total gain, the effective tax rate on his real gain is 56%!

Despite the increasing demand for forest products (and hence timber) investors cannot put money in timber operations when the tax burden is simply too high. Tree farmers who persist, and some will out of pride, will see their investment financially ruined. They are likely to end up paying a federal tax that will result in their suffering an economic loss on the sale of their timber. Capital will simply no longer flow into timber growing when inflation is taxed as though it were true profit.

The consequences of the decreased flow of capital investment in timber means that lands currently owned will be less well managed, forest research will decline, forests will be harvested prior to economic maturity, planting activity will decrease and marginal lands will go out of production, timberlands will be cut over and converted to agriculture, which would lead to more agriculture surpluses. All of these fallouts will result in fewer jobs and hurt many small, rural communities. And, of course, all this will lead to less timber consumed at higher prices and significantly greater pressure to harvest timber from public lands. Currently the trend is for more public lands to be withdrawn from harvesting by the private sector.

Capital Gains Aren't Just for the Rich

Before its elimination in 1986, the capital gains rate differential was a critical component in the economic considerations of thousand of small, non-industrial private landowners -- none of whom would consider themselves "rich." However, the myth persists that capital gains benefits only the wealthy. Strikingly, a 1981 study of IRS statistics dramatically shows that over 80% of the individual returns reporting gains from the sale of standing timber had adjusted gross incomes of less than $50,000[2]. The frustrations of the "for the rich only" myth is aptly summed up by the March 16, 1988 letter to the Washington Post Editor from S. M. Stripling, the 1987 National Outstanding Tree Farmer from Georgia:

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[2] Clark, Bobby and David Paris, 1986. Sales of Capital Assets, 1981 and 1982. Statistics of Income Bulletin, Winter 1985-86, Internal Revenue Service Pub. 1136 (Rev. 1-86), pp. 65-89

> "Your statement that fifty percent of the capital gains go to upper-income people may be true, but that means that the other fifty percent goes to those of us in the lower brackets. It doesn't take much of a tax increase to put us out of business. If we are going to talk fairness, it shouldn't matter whether you're rich or poor when it comes to how capital gains are taxed."

Adverse Impact on International Competition and Trade Balance Deficits

Factors that in the long-run will result in a reduction of timber supply means that less timber will be available for export. Timber and wood products are a major factor in holding down the nation's balance of trade deficit. In 1988 forest products exports totaled $ 5.3 billion, making the U.S. a net exporter of forest products for the first time in many years. One of the adverse factors threatening the continuation of timber's contribution is the inequitable taxation of timber in this country. Most other industrial countries have lower capital gains rates than this country had and a lot of countries do not tax appreciation at all. That is, they impose no tax at all on the sale of capital assets.

Adverse Impact on the Environment

There is growing concern over the release of carbon dioxide into the atmosphere and the long-range greenhouse impact. Trees absorb carbon dioxide and experts who are addressing this serious problem have all indicated the important role that trees play in controlling the greenhouse effect. They uniformly recommend that more trees be planted. Recently, when a utility expanded its plant it learned that 5 million trees would be needed to offset the carbon dioxide that the new plant would release into the atmosphere. To its credit, the utility embarked on a program of planting that many trees around the world. A lot of this planting is being carried out in countries where the timber has been largely cut over.

Forests have always had a favorable impact on producing a better environment apart from absorbing carbon dioxide. They hold the soil in place, provide large wooded areas suitable for outdoor activities, such as hiking, camping, hunting. In addition, forests are things of beauty. Obviously, the better we manage our nation's forests the greater is the beneficial impact on the environment.

Conclusion

President Bush's proposal to restore a capital gains rate differential is an important initiative to promote long-term savings and investment. The case for capital gains is compelling, and the President's proposal is a welcome first step.

However, there are critically needed modifications required regarding its application to timber and to the forms of ownership. Both corporations and individuals should fairly be allowed capital gains benefits; the form of ownership should not determine the tax treatment of the transaction. In addition, Section 1231 assets used in a trade or business, including timber, should be qualified for capital gains treatment. These modifications would greatly improve the fairness and equity of President Bush's initiative.

The nation's publicly-owned and privately-owned forests are one of our great natural assets. Sound policy regarding the tax treatment of timber income is a vital element in the economic consideration of growing trees. We urge the Committee to actively consider President Bush's capital gains proposal, improve it as fairness and equity dictates, and for Congress to enact it.

STATEMENT OF
HOWARD SEGERMARK, PRESIDENT

INDUSTRY COUNCIL FOR TANGIBLE ASSETS

FOR THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

- - CAPITAL GAINS TAXES -- AN EVEN PLAYING FIELD? - -

The Industry Council for Tangible Assets is the national trade association of coin and precious metals dealers. Founded in 1983, ICTA members include small retail firms, distributors, wholesalers, refiners and mining companies.

President Bush has proposed legislation which would provide a special capital gains tax rate of 15% for stocks held a year or more. Certain non-depreciable investments ("collectibles") would be ineligible for special capital gains treatment, thereby making these investments subject to the top rate of 28% (or 33% if income is between $72,000 and $150,000). What the Administration seems to be saying is that stocks are a great investment but one's home isn't. For that matter, neither are investments in real assets, including gold and silver or rare coins.

We believe that there is a need to reinstate capital gains across the board and not favor one industry.

Over 6,000,000 Americans collect and utilize numismatic and precious metal items as investment vehicles. By discriminating against tangible assets--key inflation hedges--government would discriminate against intelligent portfolio diversification.

Any discrimination against investments in gold and silver, including the Eagle gold and silver bullion coins, would have detrimental effects on employment in mining states.

A 1986 study by DeSeve Economics of Washington, D.C., reported that there is no significant revenue gain achieved by taxing such tangible investments at a higher rate (and, thus, no loss at a lower rate).

The study, which was headed by Dr. Thomas Vasquez, was entitled "The Revenue Impact of Changing the Federal tax Treatment of Tangible Assets." In it, several important observations were made. With regard to the IRS's ability to judge the fiscal effects of changing tax rates on tangible assets, DeSeve said the following:

> It is interesting to note that tangible assets are not identified separately by IRS even in describing the components of this category. Instead, tangible assets are not among the nine types of assets accorded a separate listing in the category "Other Types of Assets or Transactions," it seems highly unlikely that they account for a major part of that category. It is unfortunate that, since the IRS does not keep data on breakdowns within categories, there is no way to quantify the size of tangible assets relative to the other subcategories. (Page 10)
>
> The revenue estimates are, of course, highly sensitive to the future prices of these assets. While it is beyond the scope of this paper (and economists' ability) to assess accurately these future prices, the assumption that the increase in these prices will be the same as the interest rate on financial assets is not unreasonable. The estimates are moderately sensitive to calculations of the holding period of tangible assets and the relative shares of these assets, but the projected decline in capital gains taxes from 1981 levels would not change with reasonable changes in these parameters. (Page 16)

In his commentary on how capital gains taxes effect the holding and liquidation of tangible assets, DeSeve stated the following:

> Capital gains taxes are imposed when the gain on the asset is realized rather than when the gain accrues. Thus, an investor can postpone capital gains tax liability by deferring realization of the gain. Moreover, the tax liability can be permanently avoided if the asset is held until the investor's death, because the basis of the asset shifts from the original purchase price to the market value at the time of the bequest.
>
> The level of capital gains tax rates has long been recognized influence the degree to which investors are "locked in" to investments to postpone or avoid capital gains tax liability. In recent years, a number of studies have measured the effects of these reductions on capital gains realizations. These studies were reviewed in a recently released Treasury report, Capital Gains Reductions of 1973, and the Treasury conducted further tests with more recent time series and cross-section data than were available at the time the cited studies were undertaken. The Treasury report concluded that:
>
> > "The available statistical evidence shows that the reduction in tax rates on capital gains in the 1978 Act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut, and in the long run either increased, or only lightly decreased, annual revenue from capital gains taxes." (p. 186)

On the seminal issue of the revenue impact on changes in the federal tax treatment of tangible assets, DeSeve put forth the following proposition:

> Taken as a whole, the results suggest that any effort that any effort to raise substantial revenue by increasing tax rates on capital gains, given the current parameters of the law (i.e. a realizations based tax with step-up in basis for gains transferred at death and carryover of basis for gains transferred by gift) is likely to be ineffective."
>
> The Treasury results, like most of the results from the academic studies, strongly suggest that the revenue effect of any increase in capital gains tax rates will be largely or totally offset by individual investors postponing realization of gains, either temporarily or permanently. This increased "lock in" effect could be expected to be greatest for assets such as tangible assets, where the total return from the investment is treated as a capital gain.
>
> Treasury estimated the elasticity for capital gains realizations to tax rates for three classes of assets: corporate shares, real estate, and all other assets. The elasticities measured the percentage change in realizations due to a one percent change in the capital gains tax rate.
>
> These elasticities imply that any increase in tax rates would reduce realizations substantially.
>
> For other assets, in the aggregate, a one percent increase in the capital gains tax rate would produce increases in revenues, but the increases would be substantially smaller than 1 percent.
>
> Although tangible assets are a component, albeit a small one, of the all other category cited above, one could reasonably expect the responsiveness of realizations to tax rates for these assets to be much closer to the corporate shares elasticity than the much to be much closer to the corporate shares elasticity shown for the all other category. Indeed, as noted above, it is likely that the responsiveness of tangible assets realizations to tax rate changes is unusually high.

> This is because the entire return from investment in a tangible asset results from an increase in the sales price. This is not so with many other assets. Investors in corporate stock receive dividends, and owners of real estate receive rental income. The capital gain as a percentage of the sales price is therefore greatest for tangible assets, making the tax cost of realization very high for these assets.

The above discussion argues for using an elasticity of -2 or more for calculating the revenue impact of a tax law change. It must be recognized, however, that this elasticity estimate is based on an assumed relatively small increase in tax rates from current levels. The responsiveness of realizations to large tax changes, such as eliminating the exclusion rate entirely, would be much different.

DeSeve's chief economist, Thomas Vasquez, concluded in pointing out the economic effects of discriminating against tangible asset investments:

> The previous part documented that increases in capital gains tax rates would reduce significantly the realizations of gains of tangible assets. This substantial reduction in realizations is synonymous with substantial reductions in trading activity for these assets and implies that dealers in these assets would experience sharp reductions in sales. As a result, employment in the industry could be expected to decline in some proportion to the decline in activity.
>
> Changing the Federal tax treatment of tangible assets is also likely to have a significant effect on the price of those assets. Investor demand for tangible assets is linked, at least to a significant degree, to the expected after-tax rate of return that the assets will yield. If the tax treatment of tangible assets is changed relative to other assets, the prices of tangible assets can be expected to fall relative to other assets.
> (Pages 20-22)
>
> Accordingly, [our research] presents estimates of the change in revenues from taxing tangible assets gains at ordinary rates, but under dynamic assumptions that allow for economic and behavioral changes. These estimates represent the best assessment of the net revenue impact of the tax change. These estimates assume that each one percent increase in the tax rate is accompanied by a 0.5 percent reduction in gains realizations. A 150 percent increase in the tax rate is therefore assumed to reduce realizations by 75 percent. The estimates also assume that this tax increase results in a three percent reduction in asset prices, thus further reducing capital gains and tax liability.
>
> The percentage reduction in realizations more than offsets the rise in tax rates, so that the tax increase results in a reduction in tax revenues. As [our research] shows, under dynamic assumptions the tax increase would reduce fiscal year receipts by $81 million over the 1986 to 1990 period. (Page 26)

In fact, economists we have consulted can demonstrate clear similarities between tangible assets and other portfolio assets which show that the behavioral response of taxpayers to changes in the capital gains tax rate is the same. Special capital gains treatment of tangible assets might very well provide added revenue to the federal government. We anticipate that such a reduction in the capital gains taxes for tangibles will net from $30 and $80 million over a five-year period.

Precious metals and rare coins are traded in a highly liquid, homogenous market, and prices on traded items are known throughout the industry. These are the characteristics of a vibrant investment market--one that meets the needs of millions of men and women who acquire these items as they provide an excellent balance to hedge against inflation and other market vagaries.

Accusations that tangible investments are "non-productive" stem from an empirically undocumentable theory and ignore the importance of these investments to the American mining industry and the over 5000 firms that cater to that investment demand.

In sum, the DeSeve study shows that (1.) tangible assets are likely to perform similarly to those in stocks, thus netting the federal government revenue if rates on those investments are reduced along with those on stocks; and (2.) tangible assets are empirically as "productive" as other assets. Indeed, relative performance of investments must be the key and the role of tangible assets in a portfolio tends to increase the long-term rate of return on that portfolio.

The Industry Council for Tangible Assets urges the Subcommittee reject the President's proposal and recommend a special capital gains tax that provides a level playing field. Only nondiscrimination among investment alternatives allows the marketplace to allocate investment resources rationally.

Our organization stands ready to provide your panel with added expert testimony on this and related issues at any time.

IBM International Business Machines Corporation

Office of the IBM Director
Public Affairs

1801 K Street, Northwest, Suite 1200, Washington, District of Columbia 20006

May 24, 1989

The Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On April 12, 1989 the Ways and Means Committee had a hearing on the President's FY'90 Budget Revenue Proposals. One of the proposals was the allocation of U.S. R&D expenses for foreign tax credit purposes (IRS Section 861) and its effect on U.S. corporate income tax payments.

Since 1980, IBM has paid many billions of dollars in U.S. federal corporate income taxes net of any refunds. For 1987, the IBM Corporation paid significant federal corporate income taxes net of any refund. IBM's 1988 annual report clearly states that actual federal corporate income taxes payable for 1987 and 1988 will be greater than the annual report amounts.

For 1986, 1987, and 1988, the IBM Corporation allocated R&D expenses for federal corporate income tax purpose as required by U.S. Federal law.

The Section 861 provisions, which allocate a large percentage of U.S. R&D expense to foreign income regardless of where the research was conducted, have the perverse effect of forcing a company to consider where its R&D is performed to match a new "reality" created by the tax law. Otherwise, U.S. expenses, thus disallowed by the arbitrary allocation to foreign income, are rendered undeductible anywhere. Certainly, no foreign tax authority would permit a deduction of U.S. R&D expenses from income earned within its jurisdiction.

IBM would appreciate the inclusion of this statement in the official record of April 12th hearing.

Sincerely,

D. C. Worth

D. C. Worth

DCW/ tjp

STATEMENT OF INVESTMENT COMPANY INSTITUTE
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
HEARING ON REVENUE PROPOSALS CONTAINED IN THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1990

May 5, 1989

The Investment Company Institute respectfully submits this statement in connection with the Ways and Means Committee review of the revenue proposals contained in the President's Budget for Fiscal Year 1990. Specifically, the Institute's statement focuses on the special problems that would be created for regulated investment companies (RICs) and their shareholders should either the President's capital gain proposal or, alternatively, multiple tier capital gains or indexing proposals be enacted without modification.

I. INTRODUCTION

The Investment Company Institute is the national association of the American investment company industry. Its membership includes 2,870 open-end investment companies ("mutual funds"), 155 closed-end investment companies and 14 sponsors of unit investment trusts. Its open-end investment company members have assets of about $821 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders. The vast majority of open-end and closed-end investment companies are organized as RICs.

II. CURRENT TREATMENT OF CAPITAL GAINS AND LOSSES BY RICS AND THEIR SHAREHOLDERS

Under Subchapter M of the Internal Revenue Code, dealing with the taxation of RICs and their shareholders, the RIC investor is, to a large extent, put in the same tax posture as a direct investor in securities. Section 852(b) provides that, if the RIC distributes its net capital gain to its shareholders, the RIC pays no capital gains tax but the shareholders include the capital gain in their income. Long term capital gains designated by the RIC as capital gain dividends are treated by RIC shareholders as long-term capital gains. Short-term capital gains realized by RICs do not flow through to RIC shareholders as such and, therefore, cannot be offset by unrelated short-term capital losses incurred by shareholders. Instead, short-term capital gains realized by RICs are treated like any other item of ordinary income to the RIC shareholder. Net capital losses of a RIC do not flow through to shareholders but are carried over by the RIC to future years. A RIC shareholder treats capital gain or loss realized on the sale of RIC shares as long-term or short-term based upon the holding period in those shares.

III. THE PRESIDENT'S CAPITAL GAIN PROPOSAL

The President's capital gain proposal would provide a maximum tax rate of 15 percent applicable to any gains realized by individuals on qualified assets. To be eligible for this special capital gains rate, assets sold in 1989 through 1992 would have to be held more than 12 months, assets sold in 1993 and 1994 would have to be held more than 24 months and assets sold in 1995 and thereafter would have to be held more than 36 months.

Were Congress to enact the President's capital gain proposal, the tax treatment of RICs and their shareholders would be fairly straightforward. The General Explanations of the President's Budget Proposals Affecting Receipts, issued by the Treasury Department in February 1989, provides that the "[d]isposition of a qualified asset by a [] RIC ... would continue to be treated as capital gain under the budget proposal and would be eligible for the exclusion in the hands of individual investors." We assume that, consistent with current law, a RIC shareholder receiving a divided designated as a long-term capital gain dividend under Code section 852(b)(3)(C) would treat that amount as a long-term capital gain. Of course, the disposition of a taxpayer's shares in the RIC itself would be eligible for long-term capital gain treatment only if the taxpayer satisfied the applicable holding period.

Lengthening the holding period for long-term capital gain treatment would, however, exacerbate an existing inequity in the taxation of RIC shareholders as compared to direct investors unless RICs are permitted to flow through to shareholders all capital gains, short-term as well as long-term. Under current law, capital gains realized by a RIC on assets held for one year or less are flowed-through to shareholders as ordinary income dividends rather than as short-term capital gains. If the President's proposal were enacted without modification, additional capital gains realized by a RIC, i.e., all gains on assets held for three years or less, would lose flow-through treatment and would, instead, be treated as ordinary income that could not be offset by a shareholder's unrelated capital losses.

For this reason, the Institute believes that any capital gain proposal extending the holding period for long-term capital gain treatment beyond one year should permit RICs to flow through to their shareholders gains which may be designated in accordance with the holding period category from which they are derived.

IV. MULTIPLE TIER CAPITAL GAIN HOLDING PERIOD PROPOSALS

Legislative proposals to increase the number of capital gain holding periods from two to three or more, such as five, would create many technical issues for RICs and would exacerbate an existing inequity in the taxation of RIC shareholders. These issues arise because (1) as noted above, short-term capital gains currently do not flow through to RIC shareholders as such, and (2) RICs do not flow through their capital losses to shareholders but instead net these losses against capital gains and carry over excess capital losses to future years.

Increasing the number of capital gain holding periods would heighten the existing discrimination against RIC shareholders as compared to direct investors, unless RICs could flow through to their shareholders capital gains attributable to each of the proposed holding period categories. For example, if five holding period categories were created and capital gain dividend designations could only be made with respect to one of these categories, capital gains realized by the RIC in each of the other four categories would be flowed-through to the investor as ordinary income dividends. The direct investor, however, would be able to net capital gains against capital losses in all five categories.

For this reason, the Institute believes that any capital gain proposal with more than two capital gain holding periods should permit RICs to flow through to their shareholders gains which may be designated in accordance with the holding period category from which they are derived.

A second issue in the multiple holding period proposals arises in determining how RIC capital losses in one category could offset RIC capital gains in another category. "Stacking" rules will be needed to determine how RICs, as well as other taxpayers, will offset gains and losses in different categories.

In developing such "stacking" rules, losses in one category could be netted against gains in another category either before or after the applicable inclusion percentages are applied to determine what portion of each category's gain is to be included in income. Between 1934 and 1942, when federal law provided five and then three holding periods, the relevant inclusion percentage was applied first to each capital gain category. Thus, in 1934, when the inclusion rate for assets held less than one year was 100 percent and the rate on assets held for 10 years or more was 30 percent, $1 of short-term (1 year) capital loss offset $3.33 of long-term (10 year) capital gain. We assume that, because of the tax planning opportunities that would be created by applying inclusion percentages prior to netting, capital gains and losses would be netted under a "stacking" rule before applying inclusion percentages.

A determination must also be made whether a loss in one category would be netted first against gains in categories with longer holding periods and hence smaller inclusion rates, or netted first against categories with shorter holding periods and hence larger inclusion rates. The impact of this decision may be illustrated by the following example.

Assume a three-holding-period system under which assets held for one year or less are subject to 100 percent inclusion, assets held for more than one year and less than five years are subject to 75 percent inclusion, and assets held for five or more years are subject to 50 percent inclusion. Also, assume a taxpayer who has the following gains and losses:

net short-term gain or loss:	+$100
net middle-term gain or loss:	-$100
net long-term gain or loss:	+$200

If gains or losses are netted up, i.e., middle-term gains or losses are netted first against long-term gains or losses, the taxpayer will pay $42 in total tax:

	Income	Inclusion	Tax
net short-term gain or loss	+$100	$100	$28
net middle-term gain or loss	0	0	0
net long-term gain or loss	+$100	$ 50	$14
			$42

If the gains and losses are netted down, i.e., middle-term gains or losses are netted first against short-term gains or losses, the taxpayer will pay $28 in total tax:

	Income	Inclusion	Tax
net short-term gain or loss	0	0	0
net middle-term gain or loss	0	0	0
net long-term gain or loss	+$200	$100	$28

We assume that revenue considerations would dictate the manner in which netting is to be accomplished.

V. INDEXING PROPOSALS

Several proposals to index the basis of capital assets, including H.R. 719, have been introduced in Congress this year as alternatives to adjusting the rate applicable to capital gains. Enactment of these indexing proposals would require special provisions for RICs and their shareholders.

Two levels of indexing would apply to RICs and their shareholders under these proposals.

First, the RIC itself would index its basis in "indexed" assets, such as corporate stock. This indexing would protect RIC shareholders from paying tax on the gains attributable to inflation that otherwise would be realized by the RIC and distributed to shareholders as either capital gain dividends or, in the case of short-term capital gains, ordinary income dividends. Indexing at the RIC level would prevent the RIC from realizing "inflation gains" when an indexed asset is sold by the RIC.

Second, RIC shareholders would index the basis of their RIC stock to protect against paying tax on inflationary gains in the value of the RIC stock itself when that stock is disposed of by the shareholder.

The first type of indexing, RIC portfolio indexing, is relatively straightforward. For example, H.R. 719 would adjust the RIC's basis in its stock portfolio by the applicable inflation ratio, which is calculated by dividing the gross national product (GNP) deflator for the calendar quarter in which the disposition takes place by the GNP deflator for the calendar quarter in which the asset was acquired by the RIC (or, if later, the calendar quarter ending December 31, 1989). One complication arises from the special rule in H.R. 719's new Code section 1022(d)(2) that would reduce the applicable inflation ratio for calendar months during which the RIC is in a short sale position with respect to property substantially identical to the indexed asset. This rule, while perhaps necessary to maintain the integrity of the indexing system, would complicate the calculations of the applicable inflation ratio for RICs hedging their portfolio investments with short sale positions. In addition, existing uncertainty in current law regarding the exact definition of a short sale position in certain hedging transactions would make such a rule more difficult to apply.

The second type of indexing, that of the shareholder's RIC stock, while critical to the fairness of any indexing proposal, requires detailed recordkeeping and numerous computations. H.R. 719, for example, would provide that stock in a qualified investment entity, such as a RIC, shall be an indexed asset for any calendar month in the same ratio as the value of the RIC's assets at month-end which are indexed assets bears to the value of all of the RIC's assets at month-end (the "indexed asset calculation"). A safe harbor in the bill provides that if 90 percent or more of the RIC's assets were indexed assets for any month, the RIC would be deemed to be fully (100 percent) invested in indexed assets. Conversely, if 10 percent or less of the RIC's assets were indexed assets, the ratio for that month would be zero, i.e., the RIC would be deemed to hold no indexed assets.

The 90 percent safe harbor does not eliminate the need for computing the indexed asset calculation for most RIC shareholders for two reasons. First, the 90 percent safe harbor cannot be used by the majority of RICs holding any common stocks. At year-end 1988, approximately 2,300 mutual funds reported common stock ownership data to the Institute; of the 878 funds having more than 10 percent of their assets in stocks, only 351 funds, less than 40 percent, could qualify for the 90 percent safe harbor.

Second, those RICs that fall within the 90 percent safe harbor for one month typically will not do so for all successive months. For example, during 1988 the number of funds meeting the 90 percent test at quarter-end ranged from a low of 316 on September 30 to a high of 357 on December 31. If the safe harbor test is not met for every month, detailed computations must be performed to determine the actual ratios to be used for the indexed asset calculations.

The 90/10 safe harbor may be relatively effective for shareholders in RICs investing primarily in debt obligations and for shareholders in those RICs that satisfy the 90 percent threshold. On the basis of assets held at year-end 1988, funds with less than 10 percent of their assets invested in common stocks accounted for over 60 percent of all funds reporting common stock ownership data to the Institute, and funds with at least 90 percent of their assets invested in common stock accounted for an additional 15 percent of all funds reporting this data. (See Appendix A). However, shareholders in the remaining 23 percent of all funds, i.e., those funds holding between 10 and 90 percent of their assets in common stock, would not be covered by the safe harbor.

Our statistics suggest that changing the safe harbor test to 80/20 would almost cut in half the number of RICs for which shareholders would be required to use the actual ratio of the RIC's indexed assets to total assets. Most of this reduction is attributable to the approximately 10 percent of all funds that held between 80 and 90 percent of their total assets in common stock as of year-end 1988. However, even if an 80/20 test were enacted, shareholders in over 10 percent of the funds reporting common stock data would be required to use actual, fluctuating ratios to calculate the extent to which RIC stock is an indexed asset.

The indexed asset calculation is also complicated because the determination of the extent to which a shareholder's RIC stock is an indexed asset must be made on a monthly basis. Thus, with respect to each share of RIC stock, a shareholder would have to (1) determine the applicable ratio for each month during which that share was held; (2) average all of these ratios together and, (3) apply the averaged ratio to the adjusted basis of the share of stock. Because of portfolio fluctuations, shareholders of a RIC holding, on average, 92 percent of its assets in common stock could easily lose the benefit of the safe harbor since, in any given month, the actual ratio could fall below 90 percent. Once the safe harbor is lost for a single month, the shareholder will be required to average the ratios for each month to calculate the extent to which RIC stock is an indexed asset even though the 100 percent safe harbor might apply for all other months.

The need for some simplification beyond the 90/10 safe harbor may be illustrated by the following example. Assume that a RIC shareholder participates in a monthly purchase plan for shares in RIC X (which invests primarily in equity securities) for five years and redeems all the shares at the end of year five. Assume further that RIC X always invests at least 80 percent of its assets in corporate stock, averages an 85 percent investment in corporate stock and periodically has over a 90 percent investment in corporate stock. As the price at which the RIC X shares are purchased varies from month to month, the shareholder will have 60 blocks of stock, one purchased each month, each with different adjusted bases.

To index the basis in the first acquired block of stock, the shareholder will have to determine the actual ratio of the RIC's indexed assets to total assets for each of the 60 different months that the block was held. For some of these months the 90/10 safe harbor will apply, and shareholders will be able to treat the RIC shares as 100 percent indexed assets. However, because the safe harbor will not be met for all months, the 60 actual and safe-harbor (100 percent) ratios will have to be averaged to determine the extent to which the RIC shares will be treated as indexed assets. The indexed portion of the shareholder's adjusted basis in this single block of stock will then be multiplied by the applicable inflation ratio and the remaining non-indexed portion of the adjusted basis will be added to the product of the preceding calculation to determine the indexed basis for the asset. This calculation will provide only the shareholder's basis for those shares acquired in the first month of the five years.

Because each block of purchased shares will have a different adjusted basis and because the applicable inflation ratio will be different for shares purchased in different quarters, the computations performed on the first block of stock will need to be performed for each of the remaining 59 blocks of stock held by the shareholder. Without assistance, shareholders would find these computations to be time consuming and confusing. Moreover, this illustration does not reflect the impact on the computation of other common occurrences, such as random purchases of RIC stock, the reinvestment of dividends in additional shares and periodic redemptions of specified blocks of stock.

The ease with which indexing could be applied to RIC shares would be enhanced if the proposal were modified so that (1) determinations of the extent to which RIC stock will be treated as an indexed asset would be made quarterly rather than monthly and (2) the safe harbor provision: (a) treats the ratio of indexed assets to all assets as being 100 percent if 80 percent or more of the RIC's portfolio is in indexed assets, (b) treats the ratio as being 50 percent if between 20 and 80 percent of the RIC's portfolio is in indexed assets, and (c) treats the ratio as being zero if 20 percent or less of the RIC's portfolio is in indexed assets.

VI. CONCLUSION

Should the Committee determine to act on either the President's capital gain proposal or any alternative proposal, the Institute urges consideration of modifications needed for regulated investment companies and their over 30 million shareholders. We would be pleased to meet with the staff of the Committee and offer our assistance in developing practical solutions to these issues.

APPENDIX A

MUTUAL FUNDS REPORTING TO THE INVESTMENT COMPANY INSTITUTE CLASSIFIED BY THE PERCENTAGE OF TOTAL NET ASSETS INVESTED IN COMMON STOCK, DECEMBER 31, 1988

PERCENT OF TOTAL NET ASSETS IN COMMON STOCK	NO. OF FUNDS	VALUE OF		VALUE OF NET ASSETS (THOUSANDS OF $)	PERCENT DIST.
		PERCENT DIST.	COMMON STOCKS (THOUSANDS OF $)		
0	1,339	58.2%	$	$503,888,648	70.5%
1 - 9	85	3.7	785,726	34,589,562	4.8
10 - 19	25	1.1	349,057	2,274,767	0.3
20 - 29	20	0.9	119,261	460,152	0.1
30 - 39	25	1.1	978,214	2,767,745	0.4
40 - 49	42	1.8	3,485,672	7,447,343	1.1
50 - 59	39	1.7	5,012,028	8,732,121	1.2
60 - 69	68	2.9	9,928,608	15,308,805	2.1
70 - 79	82	3.6	9,531,983	12,860,639	1.8
80 - 89	226	9.8	51,150,841	60,079,568	8.4
90 + OVER	351	15.2	63,018,262	66,400,754	9.3
TOTAL	2,302	100.0%	$144,359,652	$714,810,104	100.0%
FUNDS NOT REPORTING COMMON STOCK DATA	416			$ 95,437,212	
TOTAL ALL FUNDS REPORTING TO INST.	2,718			$810,247,316	

Mortgage Bankers Association of America
National Association of Home Builders
National Association of Realtors

April 17, 1989

The Honorable Dan Rostenskowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We are encouraged that the Committee is closely evaluating the FY 1990 Budget proposals of the Bush Administration to determine the effect of these proposals on Federal programs and entities and their characterization as user fees or taxes.

The FY 1990 Budget proposes imposition of housing taxes, under the guise of "user fees", on the Government National Mortgage Association's (GNMA) Mortgage Backed Securities (MBS) program, and the government-sponsored housing enterprises supporting the secondary market. These fees would exacerbate the current problem of housing affordability by establishing taxes on housing.

The budget proposes imposition of a 10 basis point (a basis point is 1/100th of 1 percent) fee on the MBS program in FY 1991, to increase to 15 basis points in FY 1992. GNMA operates an extraordinarily effective program on an actuarially sound basis. In FY 1990 alone, GNMA's revenues are projected to exceed outlays by $314 million. GNMA currently administers a reserve fund with a balance in excess of $2.2 billion. Losses paid from the reserve fund have been minuscule, amounting for the full 20 year history of the program to less than one basis point of the mortgage-backed securities outstanding at the end of FY 1989. Consequently, there is simply no need for the 10 or 15 basis point fee. The fees are plainly taxes.

The budget also proposes to impose fees on the issuance of mortgage backed securities by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), in addition to fees on debt issuance by those corporations. It is particularly specious to label the proposal "user fees" because both these companies are owned by their shareholders and receive no government appropriations. In fact, both FNMA and FHLMC pay corporate Federal taxes.

Congress has rejected proposals to impose similar "user fees" in the past (P.L. 100-14, 242), and we urge you to do so again.

Interest rates are rising, homeownership is falling, and affordable rental housing is disappearing. We hope that Congress will reject ideas that exacerbate the current crisis, and continue to work toward Federal budgetary and economic policies that strive to provide adequate housing for all Americans.

Sincerely,

The Mortgage Bankers Association
The National Association of Homebuilders
The National Association of Realtors

NAGE SEIU
NATIONAL ASSOCIATION OF GOVERNMENT EMPLOYEES
AFFILIATED WITH SERVICE EMPLOYEES INTERNATIONAL UNION, AFL/CIO
1313 "L" STREET, N.W., WASHINGTON, D.C. 20005
202/371-6644

The National Association of Government Employees is an affiliate of the Service Employees International Union, the sixth largest union in the AFL-CIO. As a public sector labor organization NAGE represents thousands of state and local government employees across the country. On behalf of our members, NAGE would like to thank the Committee for this opportunity to present our views on the Administration's FY 90 Budget Proposal seeking to extend mandatory medicare coverge to all state and local government employees.

NAGE is vigorously opposed to the Administration's proposal on a number of grounds. Overall, NAGE believes that the Administration's plan constitutes a short sighted and ineffective attempt to address federal budgetary concerns without regard for the drastic consequences for state and local governments, their employees, and the general public. In the long term the Administration's proposal fails as a revenue gaining device, and will cause widespread fiscal chaos and disruption at the state and local level.

Extending mandatory medicare coverage as proposed by the Administration would impose a new, overwhelming, cost burden upon state and local governments. As currently proposed, the Administration's plan would impose significant payroll cost increases on state and localities. Public employers and their employees alike would be forced to contribute an additional 1.4% of payroll to the Medicare program. An immediate and severe financial impact would be felt by public employers faced with such drastic increases in payroll costs. While increasing payroll costs, enactment of the proposal will also jeopordize the status of those state and local government health and benefit plans already in existence. Just as these plans will be placed at risk, so too will the employees relying on them face an uncertain future. This hardship on state and local governments is not worth the limited amount of revenue raised.

It is already well established that state and local governments are struggling with the effects of recent federal budget cutbacks. The current proposal will result in almost unavoidable increases in local taxes, and/or further reductions in the services that state and local governments are able to provide to their citizens. The requisite service cuts, or tax increases, will be particularly severe in those jurisdictions which mandate a balanced budget.

As dramatic as the impact of this proposal will be on state and local governments, the impact on individual public employees is potentially as devasting. As noted above, existing state and local health plans will be particularly hard hit by the Administration's proposal. If Congress should enact the Administration's proposal a public employee earning $23,000 annually will pay a Medicare tax of $334. For approximately 4.5 million Americans the proposal thus constitutes a tax increase that completely negates the benefit of the Tax Reform will mean that for the middle class public employee earning $23,000 there will be no tax cut. Instead of the tax cut they had anticipated, these public employees will receive a net tax increase.

Act of 1986. Indeed, adoption of the Administration proposal As noted earlier, the Administration's proposal is an attempt to raise revenue at the expense of the welfare of state and local governments and their workers. Similiar versions of this proposal have been properly rejected several times in the past. The proposal is merely a short term revenue raising device that does little to improve the current federal budget crisis while greatly aggravating problems at the state and local level. In any event, there is, in reality, no need for this proposal. In the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Congress adopted legislation that will gradually extend mandatory medicare coverage. Under "COBRA", all newly hired state and local government employees will be brought under mandatory medicare coverage as they enter the workforce. Eventually, through normal workforce turnover, all state and local government employees will be covered by Medicare. "COBRA"s gradual phase in of new hires into the Medicare Program allows state and local governments to preserve the integrity of their existing health and benefit plans without the fiscal upheaval and distruption that will follow in the wake of the Administration's proposal. Unlike the Administration's plan, "COBRA" represents an appropriate compromise between federal and local interests in this matter.

Once again, NAGE asks that you reject any proposal that will substitute a short term, ineffective budget fix at the expense of the fiscal integrity of state and local governments, and the honest expectations of their public employees.

STATEMENT OF MARTHA McSTEEN, PRESIDENT NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

I am Martha McSteen, President of the National Committee to Preserve Social Security and Medicare. The National Committee would like to comment on three of President Bush's proposals to raise revenues which we be believe negatively affect seniors. The first is the President's proposal to increase Medicare premiums $7.7 billion over five years. We know that this proposal has received little publicity, but it is essential that Congress refrains from imposing this additional burden on top of the new premiums and surtaxes to pay for the catastrophic benefits.

We support in principle the extension of the Medicare payroll tax to all state and local employees and excise taxes for the Airport and Highway Trust Funds, but we don't believe that this revenue should be earmarked for deficit reduction.

Finally, we would like to bring to the attention of the Committee that the President's Budget estimates 55 percent higher revenues in 1990 from the Medicare surtax than CBO estimated last summer. Over five years this amounts to almost $7 billion -- revenue that should not be used for deficit reduction.

Seniors Would Pay $518 More Over Five Years Under Administration's Budget

The Administration is asking Congress to continue passing on to Medicare beneficiaries the inflated costs of doctors' services. That is, you are being asked to again extend the supposedly temporary provision that now requires beneficiaries to cover 25 percent of total Part B costs through premiums. The Administration thereby hopes to realize $0.2 billion in additional revenue next year, and a total of $7.7 billion by the end of 1994. It will be even more unless Congress restrains doctor fees at least as much as the Administration has proposed.

How will this affect beneficiaries? Basic annual premiums (excluding the new catastrophic premium) would increase 78 percent from $27.90 a month in 1989 to $49.70 in 1994 (see Table 1). Total premiums including the catastrophic premium would be over $700 a year in 1994 --that's more than one month's benefit for today's average retired worker. Over the next five years, seniors and disabled Medicare beneficiaries will pay $518 more for premiums than they would have paid under current law.

Table 1
Bush Proposal Would Increase Part B Monthly Premiums

Current Law Capped at COLA		Bush Proposal 25% Formula		Difference Monthly		Yearly
1990	$29.00	1990	$31.40	$ 2.40	x 12 =	$ 28.80
1991	$30.00	1991	$35.00	$ 5.00	x 12 =	$ 60.00
1992	$31.20	1992	$38.60	$ 7.40	x 12 =	$ 88.80
1993	$32.20	1993	$43.90	$11.70	x 12 =	$140.40
1994	$33.00	1994	$49.70	$16.70	x 12 =	$200.40
				Total increase over five years:		$518.40

Source: Health Care Financing Administration

Prior to 1984, the formula for the Part B premium increase was tied to the increase in Social Security beneficiaries' cost-of-living adjustments (COLAs). It was a formula that Medicare beneficiaries could understand and live with.

Congress temporarily changed the formula and increased premiums to make them cover 25 percent of program costs in 1984 and 1985. This temporary provision has already been extended several times. It has now expired -- unless Congress adopts the Administration's misguided proposal to make it permanent.

The 25 percent formula, however, is both unfair and self-defeating. The proposed premium increases do nothing to control the underlying factors resulting in skyrocketing medical inflation and will undermine Medicare's promise to make quality health care affordable.

Medicare outlays for doctors' services increased at an annual rate of 15 percent from 1980 to 1988, resulting in a tripling in spending for doctor fees. This was the recent testimony from Paul Ginsburg, executive director of the Physician Payment Review Commission.

By and large it is doctors, not patients, who decide when "intensive" services such as specialty surgical procedures are necessary. Yet doctors have little incentive to limit services to those that are medically necessary or to offer the most cost-effective therapies available. Doctors for the most part set their own fees. Congress would be shirking its responsibility to address these problems if it passed on the costs to beneficiaries via the 25 percent formula.

Clearly, this is no way to "restrain modestly the growth in Medicare payments," which is the Administration's stated goal. The National Committee urges you to reject the Administration proposal proposal, and to limit Part B premium increases to cost-of-living adjustments (COLAs).

New Medicare Revenues Should be Dedicated to Beneficiary Relief

From the perspective of universal coverage and good health policy, the National Committee supports the proposal to require all state and local government employees and their employers to pay the Medicare payroll tax. Only one quarter of state and local employees are not covered by Medicare. Many of these workers become eligible for Medicare coverage through a spouse or on the basis of shorter periods of work in covered employment while most people pay into the Medicare trust fund during all their working years. Others need the valuable Medicare protection for which they would not be eligible otherwise. This would only affect one-quarter of state and local employees -- those hired before April 1, 1986 -- and would remove the inequity in the financing of Medicare coverage.

However, while we agree in principle with the Administration's proposal, we object to using this revenue for deficit reduction. The purpose of collecting new Medicare revenue should be to bring relief to beneficiaries struggling with high premiums. In a letter to 60 Members of Congress who asked that the Ways and Means Committee hold hearings on the financing of the Medicare Catastrophic Coverage Act, your colleague Congressman Stark explained that financing alternatives to "seniors only" financing -- including the extension of the Medicare payroll tax to all state and local government employees -- were not adopted because of "constraints imposed by President Reagan" and controversial aspects of the financing proposals. If these constraints and controversial issues have been overcome, this revenue should be dedicated to fixing the flawed financing of the catastrophic law.

Trust Fund Revenues Should Be Used For Dedicated Purposes

It is misleading to American taxpayer to levy taxes for a specific purpose and then use those taxes to offset general revenue deficits rather than spend them for the purpose for which they were collected.

The Airport and Airway Trust Fund is an excellent example. The previous Administration argued that airline passengers should pay for improvements in airports and airways through user fees. But rather than spending that money on improving air safety, the Administration has let the trust funds accumulate to help reduce the deficit.

To put a stop to this shell game, 1987 legislation extending airway and airport improvement excise taxes specifically provided that the user fee on airline passengers would be cut in half on January 1, 1990, if at least 85 percent of the taxes collected in 1988 and 1989 were not appropriately used. Now, the Administration asks for authority to continue collecting airport and airway user fees even though it has not spent previously collected taxes on vitally needed airport improvements or inspections of aging aircraft.

Rather than accede to the Administration's request for a repeal of the tax reduction trigger in the Airport and Airway Trust Fund excise tax, this Committee can, by retaining the trigger, make a statement to taxpayers that trust funds will not be misused. Instead of repeal, we would urge this Committee to enact similar tax reduction triggers in every other trust fund that is currently being misused to disguise general revenue budget deficits. For the Social Security Trust fund, we recommend a trigger to reduce payroll taxes whenever the trust fund reserve is greater than one year's expenditures. This is similar to a proposal by former Social Security Chief Actuary Robert Myers.

Overestimated Revenue From The Catastrophic Surtax

The Administration budget indicates that both the Congressional Budget Office and the Health Care Financing Administration have seriously underestimated the revenue from the Medicare catastrophic surtax (see Table 2). The Administration estimates that in fiscal year 1990, $6.6 billion will be collected from this new tax on seniors -- a full 55% more than the $4.2 billion CBO estimated last summer. There is no indication that benefit costs have been underestimated significantly. Asking seniors to pay the entire cost of new catastrophic benefits is bad enough without requiring seniors to pay additional tax dollars -- only to be used to reduce the deficit.

Table 2
Current Surtax Revenue Estimates are Higher Than Last Year

		Treasury/Administration	
	CBO 1988	HCFA 1988	Budget 1989
		(in billions)	
1989	$0.315	$0.388	$0.600
1990	4.247	4.457	6.600
1991	4.922	5.944	7.200
1992	5.644	6.308	6.900
1993	6.511	6.918	7.300
Total	21.659	24.015	28.600

Sources: Congressional Budget Office, Medicare Catastrophic Coverage Act of 1988, Staff Working Paper, August, 1988, p. 21, for CBO and HCFA/Treasury. Budget of the United States Government, Fiscal Year 1990, p. 4-11 and the Office of Management and Budget for Administration Budget.

Conclusion

While members of the National Committee are as concerned as are all Americans about deficit reduction, not all of the proposals to raise additional revenue pass the test of good policy. We urge you to reject several of the Administrtation's proposal to raise additional revenues -- particularly the increase in the Part B premium.

STATEMENT OF THE NATIONAL COUNCIL OF COAL LESSORS TO THE HOUSE COMMITTEE ON WAYS AND MEANS

SUBMITTED May 10, 1989.

The National Council of Coal Lessors is an association whose members include coal land owners of all sizes from most of the important coal producing regions in the country -- from small coal land owners to large corporate coal lessors. These individual and business entities lease the coal to third parties who mine the coal and pay royalties.

From 1951 to the present, Congress has recognized the merits of income from coal being afforded capital gain tax treatment due to the peculiar nature of the investment. The Tax Reform Act of 1986 eliminated the preferential tax treatment for any long-term capital gains but retained the statutory structure to facilitate the reinstatement of the long-term capital gains rate differential if there was a further tax increase.

Coal Landowners' Position

The National Council of Coal Lessors takes the position that, as in the past, the coal land owner should have the option of either (1) electing to be taxed at capital gains tax rates with cost depletion, or (2) to elect ordinary income tax rates but be allowed to take the available percentage depletion currently at 10%.

Because Congress has changed the tax laws nearly every year recently in some way, and appears likely to continue to make yearly changes, the tax situation for the various entities becomes very complex because the various tax elements interact. The coal landowners need the flexibility for ascertaining which approach is more equitable in their individual situations. If income tax rates went up slightly to allow a small capital gains tax rate differential in many instances would not be worth losing percentage depletion for a capital gains tax rate differential but again each situation is unique and interacts with other provisions of the Internal Revenue Code.

Coal landowners seek some recognition for depletion of a wasting asset and the incredible effects of inflation over time which results in the taxation of phantom income.

The basic difference between an outright sale of a coal property and a disposal contract, such as a coal lease, is that in a sale ownership is transferred immediately with payment of the agreed sale price in a lump sum or in stipulated installments; whereas, in a lease, ownership is transferred and stipulated payments per ton of coal are made as mining takes place.

Historically most tracts of coal lands are not sold outright but are leased to coal mine operators. As a consequence, title to the coal does not normally pass from the owner of the coal to the operator until the coal is actually extracted. The persuasive use of a lease rather than an outright sale is dictated by two primary considerations.

One, neither the owner of the coal nor the coal operator can know with any precision the quality, quantity and economic value of the coal until the same is actual mined. Accordingly, a conventional coal lease, in order to insure a fair valuation of the coal itself, provides for a tonnage royalty payable by the operator to the lessor following extraction and sale of the coal.

Two, because of the cost-intensive nature of the coal mining business, most coal mine operators are unwilling to invest their capital in the coal itself but prefer to lease the coal so that they pay for the coal at the time of extraction and sale.

Thus, even though coal land owners would prefer an outright disposition, practical considerations often prevent them from doing so. Consequently, the only choice often available to a coal land owner is to dispose of his assets on a unit-by-unit basis in the form of royalties via a disposal contract as the coal is mined and sold by the operator.

Realistically, a lease of coal land authorizing the mining of coal in place in consideration for the payment to the mineral owner of a tonnage royalty following extraction and sale of the coal is the functional equivalent of an installment sale by the mineral owner of a nonrenewable asset. When so viewed, the substance and character of the consideration received by the owner in an outright sale of the coal property.

Accordingly, the income tax consequence with respect to these two types of disposition of coal in place should be the same. The inherent logic of this analysis was accepted by Congress in 1951 when it enacted legislation according capital gains treatment to coal royalties. It is our position that this treatment properly recognizes that coal royalties are the functional equivalent of the sale of a capital asset and are not in any sense ordinary income.

Coal is our most abundant energy resource. The encouragement of the development of domestic coal reserves is essential if America's effort to achieve energy independence and to reduce the nation's dependence on imported energy supplies is to be successful. Among tax incentives that have encouraged the development of coal has been the capital gain rate differential accorded property owners who dispose of their reserves by way of long-term lease arrangements. The proper sales classification of coal as a capital asset has unquestionably stimulated the development of coal properties.

With coal representing over 80% of our country's fuel reserves, its development is essential so we are not vulnerable to cutoffs of our oil suppliers. Because the owner of coal lands may not see any income for decades, they are particularly vulnerable to the effects of inflation. Therefore to tax the income from these lands at regular earned income rates would be to unfairly penalize the holders of this type asset.

A comparison of the individual taxation of the maximum long-term capital tax rate of the industrial countries of the world shows that the United States with its maximum long-terms capital gains rate currently of 33% individual and 34% corporate has become one of the highest in the world. Only Australia with 50.25%, the United Kingdom with 40% and Indonesia with 35% are higher.

From 1922 until 1986 a capital gains tax differential existed as part of U.S. tax policy for very sound economic reasons, mainly as a short way for compensating for inflation, although a better method would be to index any investment so that phantom income was not taxed. The lowering of income rates in the Tax Reform Act of 1986 and the allowance of percentage depletion had the effect of creating approximately the same tax burden as before for coal lessors though the capital gains tax differential was eliminated.

STATEMENT OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Mr. Chairman, members of the committee, the National Telephone Cooperative Association (NTCA) is the primary telephone industry organization dedicated entirely to representing and serving the interests of the nation's rural independent telephone systems. NTCA represents more than 470 small, independent cooperative and commercial telephone companies located n 42 states.

A proposal making the telephone federal excise tax a permanent tax was included in the President's revenue package.

NTCA would like to explain why making the telephone excise tax permanent is inequitable in today's deregulated telecommunications environment.

Current Law and History of Telephone Excise Tax

The federal excise tax on telephone services applies to general telephone service and toll service.

Over the last two decades there have been numerous attempts by Congress to phase down and ultimately repeal this tax. However, revenue problems have arisen before the total repeal of the tax was allowed to occur. In each instance, Congress either increased the rate or postponed the repeal date.

The fact that Congress recognizes the unfair characteristics of the telephone excise tax is illustrated in the Senate Finance Committee Report on the Excise Tax Reduction Act of 1965:

> ...the tax on local and toll telephone service and the teletypewriters exchange service is undesirable as a permanent feature of our excise tax system. This conclusion was reached on the grounds, first, that these taxes are regressive and therefore fall with greater severity on those with low incomes than those with higher incomes. Second, the charges for telephone services enter heavily into business costs. Therefore, the tax discriminates against those firms that must make extensive use of the taxed services (Senate Report No. 89-324, Excise Tax Reduction Act of 1965, June 14, 1965, pp. 34-35).

Impact of a Permanent Telephone Excise Tax

The telephone excise tax is contrary to federal excise tax policy. Other excise taxes can be categorized in the following groups: sumptuary taxes, luxury taxes, or excise taxes dedicated to trust funds. The telephone excise tax does not fit any of these categories.

A sumptuary tax is imposed on items which exact a social toll on society. The imposition of such a tax is used to help discourage the use of such products. Examples are the excise tax on cigarettes and alcohol. Telephone service is a necessity and should not be categorized as a sumptuary tax.

Other excise taxes are designed to be imposed on what many believe are luxuries. Such taxes are commonly used for revenue raising purposes and the impact of a tax is intended to be on higher income individuals. This follows our nation's philosophy that our tax system should be progressive in that those with the greatest ability to pay are taxed at a greater rate than that of low income individuals. The federal excise tax on telephone service is a tax on a necessity. The need to have access to telephone service to call a doctor, sheriff, or fire department in an emergency situation is especially essential in such sparsely populated rural areas.

The other category of excise tax is where the excise tax is levied on certain products or services and the revenues raised by such a tax are used to provide the resources for a related benefit. For instance, the tax on gasoline or other fuels is placed in a fund used to build and maintain highways.The excise tax on telephone services does not go into a special fund to provide lifeline service to low income customers. Instead, it is treated as general receipts of the U. S. Treasury.

It is clear that the current law telephone excise tax does not fit into any of the aforementioned categories.

The telephone excise is the only excise tax imposed on a household utility. There is no such tax levied on electricity, gas, or water. To subject telephone service to federal excise taxation is inconsistent in this respect also.

Unlike the other utilities, consumers of telephone service are experiencing an increase in their telephone bills in piecemeal fashion. For instance, the Federal Communications Commission (FCC) increased the subscriber line charge to $3.50 per month. In addition, many state and local governments have imposed their own tax on telephone service. 911 surcharges are also added to monthly bills in many states.

Because of the cumulative effect of these state and federal charges, telephone subscribers are already bearing a substantial tax burden. Residents of the areas which we serve are finding it more difficult to afford the necessity of telephone service in light of the depressed economic situation facing our nation's rural areas. Any further increase in the cost of providing telephone service creates an undue economic hardship for rural residents and jeopardizes our nation's goal of providing universal telephone service.

Another important factor to consider is the regressive nature of the tax. The impact of the federal excise tax on telephone service is greatest on low and middle income households. A great proportion of telephone subscribers in rural areas are from lower - and middle-income families.

The regressive nature of the tax is further exacerbated by the fact that rural residents rely on toll service for daily living and business use. Rural residents make more toll calls than their urban counterpart. For instance, it is likely that a call to a country doctor will be a toll call. With consolidated schools in the rural areas, it is also likely that a call to a child's school will be a toll call. It is even more likely that a farm equipment retailer is located in a different local exchange area than most of its customers.

Summary

Although the telephone excise tax is contrary to federal excise tax policy, we are realistic about current efforts to lower the federal deficit. We would like to see eventually the telephone excise tax repealed as it was scheduled to do at the end of 1987. However, we are aware that it will most likely continue to be extended. We would like to express our strong opposition to the tax being made permanent. Once it is made permanent, the option to eventually repeal it is much more difficult.

NTCA respectfully requests that the committee consider the points we have raised and not make the telephone excise tax permanent.

STATEMENT OF ROBERT J. SCOTT, SECRETARY-TREASURER, OPPOSE (Organization for the Preservation of the Public Employee Retirement Industry and Opposition to Social Security Expansion to Such Industry)

Members of the House Committee on Ways and Means, I am Robert J. Scott, secretary-treasurer of OPPOSE. OPPOSE is a Colorado corporation formed by teachers, firefighters, police, and other state and local government employees who have elected not to join the Social Security system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting congressional efforts to mandate Social Security or Medicare coverage of public employees. Our members are found in Alaska, California, Colorado, Illinois, Kentucky, Louisiana, Massachusetts, Minnesota, Nevada, Ohio, and Texas. With respect to the issue of mandatory Medicare coverage, the interests of OPPOSE are identical to those of the four to five million public employees throughout the nation who remain outside the Social Security system.

In its budget submission for 1990, the Reagan Administration for the third time proposed to raise revenues by requiring all state and local government employees to participate in the Medicare system, effective October 1, 1989. Along with the other Reagan revenue proposals, this measure was included in President Bush's budget plan released February 9, 1989. Under the Bush plan, the revenues raised by the payment of additional Medicare taxes would apparently be used to offset some of the costs of various revenue-losing tax proposals. Through this testimony, we wish to express our strong opposition to the mandatory Medicare coverage proposal.

By way of background, I would remind you that employees of state and local governments were not permitted to join the Social Security system when it was established in 1935. While they have been permitted to join since the 1950s, those who have chosen to remain outside the system have their own retirement plans and, in many instances, health insurance plans.

In 1985, in response to the federal government's pressing need for revenues, Congress elected to require state and local governments and their employees to pay the Medicare tax. It implemented this decision, in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), by extending mandatory Medicare coverage to all state and local government employees hired on or after April 1, 1986. By adopting this phase-in provision, which is resulting in increasing numbers of Medicare-covered public employees through normal job turnover, Congress ensured that all public employees will ultimately pay the full Medicare tax to the federal government. While we at OPPOSE did not favor mandatory Medicare coverage, we believed that the phase-in provision adopted in COBRA was a reasonable, permanent solution that avoided imposing overwhelming burdens on state and local governments and their employees.

During consideration of the Omnibus Budget Reconciliation Act of 1986, Congress threatened to abandon COBRA's phase-in by mandating coverage of those employees specifically excluded from coverage under COBRA, but, in the end, did not adopt such a provision. The issue was reopened and the same proposal was rejected by Congress in 1987.

We believe that the phase-in compromise reached in COBRA should be respected and that our employees and retirees should not be visited by the same threat year in and year out. Therefore, and for the reasons set forth below, OPPOSE asks you this year to reject the proposal to extend mandatory Medicare coverage to all state and local government employees.

1. Despite the promise of the President not to propose new taxes and the recent efforts of Congress to provide tax relief to lower- and middle-income individuals, this proposal singles out a group of 4 to 5 million lower- and middle-income Americans and their spouses for new taxes. The President campaigned on a pledge not to raise taxes and has repeatedly asserted that the budget may be balanced without new taxes. Asked to specify what measures qualify as "new taxes," Office of Management and Budget Director Richard Darman suggested application of "the old if-it-looks-like-a-duck rule, if it looks like a 'tax' to most Americans, it's a tax."

Quite simply, this measure has webbed feet and quacks. For the 4 to 5 million affected Americans, the proposal would result in the deduction from their paychecks of approximately $363 each year. No one can deny that this is a new tax under the Bush Administration's definition. And, adding insult to injury, it is the only Administration proposal to raise income or payroll taxes!

This new tax would fall on a group of people -- primarily teachers, firefighters, and police, as well as other public employees -- whose income averages about $25,000 per year. This is hardly a high level of income in an era when many federal employees making almost four times this amount can not afford to remain in government service. To consider the example of the average Illinois teacher, who makes $28,085 annually, the new tax of $407 would more than offset the meager $303 that now remains to such an individual after payment of basic expenses such as rent and groceries.

Moreover, the new tax would more than offset the tax cuts these individuals received under the Tax Reform Act of 1986. According to the Joint Committee on Taxation, the Tax Reform Act provided taxpayers with incomes in the range of $20,000 - $30,000 with a cut equivalent on the average to $220. The new Medicare tax that would be imposed upon state and local government employees equals 1.45 percent of payroll.

Thus, to cite another example, in the case of the average government employee in Colorado (whose annual salary is $25,842), the new Medicare tax of $375 would result in a net tax increase of $155. (See attached Table A setting forth state-by-state the cost of Medicare coverage to the affected individuals as well as the projected amount of his or her tax cut under the Tax Reform Act.) The increased tax burden for employees would be even higher if the 1.45 percent tax that would be newly imposed upon their employers is passed along to the employees.

2. President Bush has vowed to leave a legacy as "the Education President," leading the effort to improve the quality of education. Yet mandatory Medicare coverage would have a particularly adverse impact upon education in America. Within the past several years, the National Commission on Excellence in Education declared that America's educational system is failing both its students and the entire country. It has been recognized that one cause is the difficulty school systems face in recruiting and retaining quality teachers. The federal government has reported that the country will have 34 percent fewer teachers than it needs by 1992.

One reason for this problem is that teachers are significantly underpaid. In 1986-87 (the most recent year for which statistics are available), the average teacher's salary was $27,878, while the averages ranged state-by-state between

$19,000 and $46,082. After adjustment for inflation, the average American schoolteacher's salary has risen only 7.3 percent over the last ten years.

Mandatory Medicare coverage would only exacerbate the problem caused by low salary levels. Teaching is one of the major professions with large numbers of non-covered members. In the affected states, mandatory Medicare coverage would take an additional $404 from the average teacher's salary each year (1.45 percent of $27,878). If, as appears likely, employers attempt to recoup their own Medicare tax obligations from their employees, the average teacher's pay cut could be double that amount. As a result, many of the best qualified teachers -- particularly those with marketable skills in mathematics, science, and computers -- would leave teaching for better-paid employment. In a year in which education is to take top priority, adopting legislation that would aggravate the teacher recruitment problem appears unwise.

3. The proposal would have an extremely negative fiscal impact upon the affected state and local governments. While the impact of the proposal would fall most heavily upon governments in approximately 10 states,*/ forty-nine states include at least some subdivisions with non-covered employees that would be significantly harmed by these additional operating costs. Estimates of the annual cost to state and local governments are set forth state-by-state in Table B, attached. For example, each year, the proposal would cost governments in Illinois $79 million; in Ohio, $158 million; in Maine, $14 million, and in Texas, $129 million.

Imposition of these additional costs would come at a difficult time. Recent reports released by the National Governors' Association and the National Association of State Budget Officers found that the flexible freeze called for in the Bush budget could reduce federal aid to state and local governments by as much as $5 billion and would underfund the cost of welfare reform implementation by more than 50 percent. Moreover, state and local governments have repeatedly been forced to shoulder additional burdens in recent years, resulting from considerable cuts in the federal appropriations for many of their programs and the loss of revenue-sharing, while the Tax Reform Act of 1986 limited their ability to raise revenues, through loss of the sales tax deduction and new restrictions upon municipal bonds.

The result is that state and local governments are in no shape to absorb additional fiscal burdens. Early revenue estimates for fiscal 1989 show an average revenue growth of 5.4 percent, compared with expenditure growth of 6.8 percent -- a trend that could lead to further fiscal difficulties in the future. Two states that would be most seriously affected by the mandatory coverage proposal reported no revenue growth (Alaska and Louisiana), while two other such states (California and Massachusetts) reported lower-than-anticipated personal income tax collections.

To cite a few examples of the results of this fiscal squeeze, a number of California counties have been required in recent years to close public libraries and parks as a result of budget shortfalls. In 1987, the President of the Board of Commissioners for Trumbull County, Ohio, testified that, as a result of the loss of revenue-sharing, 39,000 citizens in his county were without police protection. Governments at all levels around the country would find that imposition of the new 1.45 percent Medicare tax would force them to make very hard choices among essential services and staff.

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*/ Alaska, California, Colorado, Illinois, Louisiana, Maine, Massachusetts, Nevada, Ohio, and Texas.

4. Mandatory coverage of public employees will not pay for other programs because the revenues raised by the mandatory coverage proposal would shortly decline to zero, while the Bush Administration's revenue-losing proposals would require permanent sources of financing. Through the operation of COBRA's provision imposing coverage on newly hired employees, job turnover has resulted in a larger percentage of the public employee workforce being covered each year. We estimate the overall turnover rate for state and local employee groups to be approximately 9 percent per year. Thus, of the state and local government employees not covered by Medicare before COBRA, approximately one-quarter are now covered.

As time progresses, fewer employees remain outside the system, representing a declining revenue base. The revenues that the mandatory coverage proposal would raise would dry up entirely in a relatively short time and would not be available for any purpose in the long run. On the other hand, the items that the Administration proposes to finance through mandatory coverage are permanent, and require a permanent source of financing. Enacting the spending proposals on the pretext that mandatory coverage would pay for them would actually exacerbate the deficit problem.

Moreover, because the Administration's revenue estimates do not reflect a decline in the amount that this proposal would raise over time, the estimates are themselves open to challenge even concerning the amount that would be raised in the first year. The Administration estimates that the mandatory coverage proposal would raise $1.8 billion in fiscal year 1990 and $1.9 billion in each of the next three years. These estimates, which do not reflect a decline in revenues in the out years, are simply inaccurate with respect to the later years and suggest that the full effect of COBRA was not taken into account in the estimate for fiscal year 1990.

By suggesting that mandatory Medicare coverage presents an available revenue source, the Administration's proposal also ignores the fact that the newly taxed individuals would also become newly entitled to benefits. Indeed, their benefits might well be relatively more expensive than the benefits of the average covered individual. Like the federal employees who were brought into the system in 1983, newly covered state and local government employees would become entitled to the full package of Medicare benefits despite having spent a portion of their careers outside the system and having paid a relatively small amount of the Medicare tax as a result. Given the projected decline in the HI trust fund's balance in the next decade, any revenues raised by an expansion of mandatory Medicare coverage would be needed to offset the cost of additional benefits.

Recent reports have indicated that the magnitude of the deficit problem the country faces in the next decade is masked, in part, because the Social Security trust funds, which are counted for purposes of deficit calculation, will begin to build large surpluses that must be expended on benefits in the next century. Congress should not add to this problem by enacting spending proposals and claiming to fund them by revenues which are credited to the HI trust fund and necessary to pay future benefits.

5. Mandatory Medicare coverage of the employees who were "grandfathered" outside the system by COBRA would create a variety of problems that were avoided by COBRA's compromise position. Some state and local governments have health plans in place for their employees, including retirees. Adjustment of these plans to take account of Medicare coverage for existing employees would prove an overwhelming task, or would result in abandonment of these plans. While COBRA affects the health benefits and take-home pay of individuals at the time they commence employment, the current proposal would displace benefits programs that individuals have enjoyed, in some cases, for many years, and would reduce the amount of take-home pay they have come to expect. Abandonment of the careful compromise adopted in COBRA would unfairly disappoint the expectations of millions of public workers.

6. Mandatory coverage can not be justified on the grounds that it would benefit the affected employees. The Reagan Administration attempted to justify its proposal with the paternalistic concern that "[a] minority of State and local government employees. . . may not be assured of medicare coverage." The response to this concern is simple: if those public employees wanted Medicare coverage, they would have it. Since the passage of COBRA, local jurisdictions have had the option of joining the Medicare system without also participating in the Social Security system. If Medicare coverage were desirable, employees would certainly bring pressure to bear upon their employers to adopt it. In fact, the opposite is true; public employee groups are vehemently opposed to mandatory Medicare coverage and do not need the federal government to provide it "for their own good."

TABLE A

ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYEES OF MEDICARE COVERAGE OF ALL EMPLOYEES

State	Annual salary of average public Employee 1/	Annual tax increase resulting from proposal 2/	Average tax decrease resulting from the Tax Reform Act 3/
Alabama	$20,004	$290	$220
Alaska	39,672	575	273
Arizona	28,044	407	220
Arkansas	18,060	262	200
California	32,700	474	273
Colorado	25,608	371	220
Connecticut	27,708	402	220
Delaware	24,132	350	220
Dist. of Columbia	32,472	471	273
Florida	23,616	342	220
Georgia	20,400	296	220
Hawaii	23,460	340	220
Idaho	19,908	289	200
Illinois	26,496	384	220
Indiana	24,996	362	220
Iowa	23,064	334	220
Kansas	20,856	302	220
Kentucky	19,692	286	200
Louisiana	18,768	272	200
Maine	20,724	301	220
Maryland	27,540	399	220
Massachusetts	26,076	378	220
Michigan	28,848	418	220
Minnesota	29,340	425	220
Mississippi	16,656	242	200
Missouri	21,300	309	220
Montana	21,588	313	220
Nebraska	20,592	299	220
Nevada	26,208	380	220
New Hampshire	21,636	314	220
New Jersey	27,348	397	220
New Mexico	20,640	299	220
New York	29,160	423	220
North Carolina	22,140	321	200
North Dokata	22,056	320	220
Ohio	24,516	355	220
Oklahoma	19,752	286	200
Oregon	24,504	355	220
Pennsylvania	24,132	350	220
Rhode Island	27,036	392	220
South Carolina	19,752	286	200
South Dakota	18,828	273	200
Tennessee	20,184	293	220
Texas	21,924	318	220
Utah	21,912	318	220
Vermont	21,768	316	220
Virginia	23,172	336	220
Washington	26,616	386	220
West Virginia	19,368	281	200
Wisconsin	25,620	371	220
Wyoming	23,268	337	220

1/ U.S. Bureau of the Census, Public Employment in 1987 - Government Employment (Series GE-87-1) at 10.

2/ The amount of the new Medicare tax is derived by multiplying the average employee's salary by 1.45%.

3/ Joint Committee on Taxation Staff, Data on Distribution by Income Class of Effects of H.R. 3838, Tax Reform Act of 1986 (JCX-28-86) (October 1, 1986), Table 4.

TABLE 8

April 1989

POTENTIAL ANNUAL COST TO STATE AND LOCAL GOVERNMENTS OF COVERAGE OF THOSE EMPLOYEES CURRENTLY NOT COVERED BY MEDICARE

State	Employees not covered by Social Security/1	Employees not covered by Medicare		Cost of Coverage (in millions of dollars)/3
		Number/2	Percentage/2	
Alabama	27,000	19,710	8.2	7.2
Alaska	40,000	29,200	51.5	10.6
Arizona	21,000	15,330	8.2	5.6
Arkansas	39,000	28,470	9.7	10.3
California	991,000	723,430	47.1	263.0
Colorado	150,000	109,500	56.7	39.8
Connecticut	63,000	45,990	27.6	16.7
Delaware	14,000	10,220	25.4	3.7
Florida	127,000	92,710	15.7	33.7
Georgia	64,000	46,720	13.5	17.0
Hawaii	24,000	17,520	24.7	6.4
Idaho	0	0	0	0
Illinois	299,000	218,270	35.9	79.3
Indiana	54,000	39,420	12.7	14.3
Iowa	5,000	3,650	1.5	1.3
Kansas	2,000	1,460	0.7	0.5
Kentucky	56,000	40,880	20.1	14.9
Louisiana	271,000	197,830	63.4	71.9
Maine	52,000	37,960	53.0	13.8
Maryland	29,000	21,170	7.5	7.7
Massachusetts	334,000	243,820	74.6	88.6
Michigan	19,000	13,870	3.0	5.0
Minnesota	96,000	70,080	24.7	25.5
Mississippi	2,000	1,460	0.7	0.5
Missouri	62,000	45,260	16.4	16.5
Montana	5,000	3,650	6.7	1.3
Nebraska	2,000	1,460	1.5	0.5
Nevada	49,000	35,770	70.2	13.0
New Hampshire	6,000	4,380	7.5	1.6
New Jersey	30,000	21,900	4.5	8.0
New Mexico	33,000	24,090	20.1	8.8
New York	153,000	111,690	8.9	40.6
North Carolina	43,000	31,390	8.2	11.4
North Dakota	6,000	4,380	7.5	1.6
Ohio	595,000	434,350	74.6	157.9
Oklahoma	33,000	24,090	11.2	8.8
Oregon	14,000	10,220	5.2	3.7
Pennsylvania	36,000	26,280	4.5	9.6
Rhode Island	25,000	18,250	32.1	6.6
South Carolina	6,000	4,380	2.3	1.6
South Dakota	2,000	1,460	3.7	0.5
Tennessee	29,000	21,170	8.9	7.7
Texas	486,000	354,780	37.3	129.0
Utah	1,000	730	0.7	0.3
Vermont	1,000	730	1.5	0.3
Virginia	72,000	52,560	13.5	19.1
Washington	36,000	26,280	9.7	9.6
West Virginia	7,000	5,110	4.5	1.9
Wisconsin	48,000	35,040	11.9	12.7
Wyoming	5,000	3,650	7.5	1.3
TOTAL	4,564,000	3,331,720		$1211.2

1/ Social Security Administration, 1985 Current Population Survey and Continuous Work History Sample, reprinted in Congressional Research Service paper "Medicare Coverage of Employees of State and Local Governments;" by David Koitz, (March 11, 1987).

2/ The Consolidated Omnibus Budget Reconciliation Act of 1985, Publ. L. 99-272, requires public employees hired after March 31, 1986, to participate in the Medicare system. Because we assume employee turnover occurs at a rate of approximately 9% per year, in the three years since COBRA took effect, approximately 27% of previously non-covered public employees are now covered by Medicare. The number of public employees not covered by Social Security has therefore been reduced by 27% to reflect the number of employees who are currently not covered by Medicare.

3/ The figures reflect only the 1.45% that would be paid by the governments as employers, and do not include the cost increase to their employees, who would also have to pay the 1.45% Medicare tax (see reverse side for increased tax burden on individual employees). Given that the employer's part of the Medicare tax is 1.45%, and the salary of the average state or local government employee is $25,068, (U.S. Bureau of the Census, Public Employment in 1987 - Government Employment (Series GE-87-No. 1) at 10), each governmental employer's cost is equal to the number of employees, multiplied by $25,068, multiplied by 1.45%.

STATEMENT OF JOHN E. WATSON, PRESIDENT
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION

Mr. Chairman and Members of the Committee:

My name is John E. Watson. I am Senior Vice-President for Governmental and Regulatory Affairs of the Mitchell Energy Corporation. I submit this written testimony as President of the Texas Independent Producers and Royalty Owners Association (TIPRO). TIPRO members are representative of the some 5,500 independent oil and natural gas producers and 750,000 royalty owners who have a petroleum interest in Texas.

TIPRO appreciates this opportunity to be heard on measures in the President's budget proposal that would provide new incentives in the tax code for domestic petroleum exploration and enhanced recovery operations. The Administration's modest suggestions to provide exploration and tertiary recovery investment tax credits, along with adjustments in percentage depletion rules and alternate minimum tax requirements, are aimed in the right direction and reveal knowledge of the energy problem. However, a review of the energy situation will, in my opinion, reveal the inadequate nature of the proposals.

CURRENT INDUSTRY CONDITIONS

American Petroleum Institute data indicates that during the decade of 1976-85, when domestic exploration activity was sufficient to hold petroleum imports in check, the domestic producing industry averaged a little over 66,000 wells drilled per year. As the result of serious industry dismantling caused by the severe and still ongoing energy recession of 1986, the industry's well total of 1988 is only slightly over 31,000, or some 35,000 below the decade average.

Energy Information Administration indicates that crude oil prices in 1988 averaged only $12.66 per barrel, compared to the highwater mark price of $31.77 per barrel in 1981, while natural gas prices averaged $1.75 per Mcf compared to $2.66 in 1984. Although crude prices in 1989 are experiencing a short term improvement, virtually no-one is predicting the improvement will last. At the same time, natural gas prices have fallen still further thus far this year.

It is this rapid and serious decline in petroleum prices that has, more than any other factor, caused the very serious decline in the industry's producible reserve replacement activity during the past three years. Drilling has dropped by more than half and initiation of enhanced oil recovery projects has virtually ceased.

Low prices have also stalled much of the consumer conservation effort that helped balance the energy ledgers during the 1976-85 decade. Thus, EIA data now indicate the combination of increase in demand and decline in domestic production caused by decreased drilling will require approximately a one million barrels per day equivalent annual increase in oil and gas imports for the foreseeable future. And virtually all this increase must come from the turbulent Middle East where most of the free world's surplus petroleum producing capacity is located.

In response to those who believe inadequacy in domestic petroleum reserve potential is the real culprit moving the nation rapidly to imported supply, available information suggests otherwise. A highly respected Department of Energy survey concluded a year ago that the nation had untapped natural gas reserves left to cover at least 35 years of foreseeable need. According to the Department, more than

1,000 trillion cubic feet remains to be found, assuming prices approach more realistic levels of $2.50 or more per Mcf.

Likewise, an impressive supply of domestic crude oil remains unrecovered in known fields, waiting for initiation of enhanced oil recovery projects and more intensive technological research. More than 300 billion barrels of oil are there waiting for recovery. Here again, however, inadequate pricing keeps most recovery projects on the shelf, waiting for improved economic conditions.

According to the Joint Association Survey of Independent Petroleum Association of America, American Petroleum Institute and Mid-Continent Oil & Gas Association, the average cost of drilling wells in 1987 (latest year available) was $279,615. This cost is significantly lower to the explorer than that experienced during the 1976-85 decade, since the entire oil industry, including the service sector, has suffered decline in prices. Nevertheless, it would take $9.8 billions at that depressed cost level to raise the annual number of wells drilled to the 1976-85 decade average. On this basis, it would mean an increase of $3.00 per barrel net of taxes and other non-drilling costs on all domestic oil now produced.

Disregarding the current, short term increase in crude prices, domestic oil and natural gas price levels simply do not allow for this kind of investment. In the absence of dramatic price improvement and/or major change in national energy policy encouraging reserve exploration and development, the industry will continue to constrict its finding activity or, at best, mark time waiting for a better day.

NEED FOR NEW NATIONAL ENERGY POLICY

TIPRO firmly believes that development of a new national energy policy, which recognizes the rapidly growing supply crisis, should be developed as soon as possible. Decisions should be made on just how much deterioration in domestic energy producibility the nation can safely absorb and now much increase in reliance on foreign supply is acceptable both in security and economic terms.

Anticipating the need for answers to these fundamental questions, TIPRO initiated last year a proposal for a national energy policy based on a "core supply" concept which refers to domestic production of petroleum energy. Usage of this term reflects recognition of the possibility that domestic petroleum supply potential may never again fully meet domestic demand for petroleum products.

At the same time, however, the term "core supply" implies that it is not in the nation's best economic and security interest to give up on domestic petroleum and let foreign supply take over in increasing ratio to demand. It is assumed by TIPRO, along with others in industry and government, that somewhere along the line, special effort must be initiated to stem the flow of imported energy, by depressing demand and by increasing domestic energy supply.

This idea was first embodied in a bill by Sen. Lloyd Bentsen (D-TX) in 1987 that established a "peril point" beyond which the nation was endangered by increased reliance on imports. His peril point was 50 percent of domestic oil demand, and when imports moved toward that trigger level, certain things were to happen to prevent further growth.

One of the chief objectives in establishing a "peril point" or preserving an agreed upon "core supply" is to head off energy supply problems before a crisis occurs.

Heretofore, nothing has been done prior to energy crises to solve the supply problem. The nation got away with that modus operandi up through the 1967 crisis, because the domestic petroleum producing industry had the surplus producing capacity needed to cover short term loss of imported supply. Since then, however, with the crises in 1973 and 1979 and in our current situation lack of excess capacity has caused considerable economic pain and disruption to national security objectives, as it requires considerable lead time for the domestic industry to increase significantly its ability to produce.

Despite the serious nature of conditions in the producing industry and the rapidly growing reliance on foreign oil, Congress has remained hesitant to deal with energy problems. Solutions remain controversial for various reasons, and there is no basic concern or crisis atmosphere to offset the controversy.

It is for this reason that TIPRO has urged the current Administration to develop a new national energy policy based on the "core supply" concept. It is hoped that a defined objective of the amount of domestic energy needed to protect the nation's best economic and security interests would act as a catalyst to make needed energy decisions more politically acceptable and less controversial.

In a speech before the National Petroleum Council last month, DOE Secretary James D. Watkins initiated plans for a new national energy policy that would highlight the need for domestic oil and gas production. Stated the Secretary: "...it is still oil and gas that must remain at the core of our strategic energy thoughts."

A week later, DOE Deputy Secretary Henson Moore further emphasized at a meeting in Amarillo, Texas, that the Administration would vigorously pursue development of a "National Energy Strategy", which would encompass analysis of the capability of petroleum and other forms of domestic energy to help meet future demand.

TIPRO eagerly awaits the Administration's leadership on this vital issue.

TIPRO has recommended that a bi-partisan forum be established by the Administration that would provide opportunity for governmental and industry representatives to sit down and quantify "core supply." It is assumed that this objective would probably encompass all forms of domestic energy, although the Association's concern, of course, rests with petroleum. It is also assumed that the "core supply" would have to be periodically updated to reflect changing conditions and needs.

Once the core supply objective is in place, then various solutions should be reviewed for administrative or legislative adoption to help secure the objective. TIPRO agrees with others in the industry that these solutions should be developed and ready for use when the time comes for adoption. This would help ease the lag time between problems and solution that has been so prevalent in crises in the past.

A LOOK AT POSSIBLE SOLUTIONS

Government and industry agreement of objectives for a national energy policy is only the first step. TIPRO believes the next decision is even more important. What are policy makers willing to do to secure the objectives?

New incentives in the U. S. income tax code that would encourage greater exploration and development activity for domestic petroleum are, of course, prime measures to consider. However, the 1986 Tax Reform Act discourages basic changes in the near future.

A second potential measure would involve the increase in governmental participation in enhanced oil recovery research. Greater recovery of the 300 billion barrels of oil in discovered reservoirs that require new technology to be brought to the surface would certainly help the "core supply" objective.

Aside from the Administration's proposals, TIPRO has given its full support to the more extensive tax changes of the Energy Security Incentive Act introduced by Rep. Mike Andrews (D-TX) during the last session of Congress and re-introduced this year (HR 658). Aimed at the independent producer, who drills 85 percent of the nation's wells and is primary caretaker of marginal well operations, the measure would be most helpful in reversing the downward trend of domestic drilling activity.

TIPRO also supports HR 664, The Domestic Energy Security act of 1989, authored by Rep. Bill Archer (R-TX). The measure would broaden tax changes to encourage all segments of the petroleum industry to increase domestic finding and recovery activity.

Growing reliance on foreign oil may eventually lead to a new import fee system or a price stabilization measure as a solution to help reverse the tide. Currently such action is dismissed as politically difficult. President Bush and others in Congress have voiced strong opposition to an import fee. But there are factors that could change the situation dramatically. For example, it is becoming increasingly clear that virtually all future increase in oil imports must come from the volatile Middle East area. That is the only place in the Free World where substantial reserve producing capacity exists.

Such reliance adds to the fact that the U. S. is becoming energy vulnerable. Aggravating this situation is the probability that oil imports into the United States will have to increase considerably in the years ahead. Sharp decline in domestic production potential brought on by industry dismantlement since the 1986 pricing crisis, combined with renewed demand by American consumers, could require annual import increases approaching one million barrels daily.

Conservation is another important factor in the effort to maintain a desirable balance between domestic and foreign energy. During the decade of 1978-88, Americans proved this by adjusting energy use habits sufficiently to stabilize demand for oil and gas, thereby interrupting a long period of growth in annual use. However, in the past two years, growth trends have reappeared. Consequently, conservation will have to be looked at again as a factor for the future.

There are still other measures to consider in the energy policy process, some more politically viable than others. A relatively popular one consists of incentives to encourage longer stripper well life. Other incentives might be designed to encourage more deep drilling for natural gas to help back out fuel oil imports. These might include an environmental fee system applied to oil imports that compete directly with domestic natural gas production on the marketplace.

It seems clear, then, that many fundamental and serious decisions must be made soon for the nation to have a long viable energy policy that is responsive to the best long range security and economic interests of American producers and consumers.

CONCLUSION

TIPRO remains strongly supportive of all proposals to initiate or restore domestic petroleum drilling incentives in the tax code. At the same time, it welcomes the Administration's recent pronouncements calling for development of a new "National Energy Strategy" that will hopefully spell out the need for maintenance of domestic energy production capability.

It is anticipated that this process will soon make clear what solutions are necessary to assure a domestic energy industry capable of serving the nation's long term security and economic interests. It is presumed that tax code incentives could rank high on that solution list.

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April 6, 1989

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

Debates over the effect of capital gains tax reductions on the flow of venture capital appear to suffer from monstrous misconceptions about the sources of venture financing for our country's entrepreneurs. The venture capital dialogue implicitly assumes that professional venture capital funds are the primary backers of entrepreneurs. The dialogue then proceeds to focus on the fact that fifty percent or more of venture capital under professional management comes from tax exempt sources. The following remarks are designed to clarify discussions of venture financing and to assist the Congress in its deliberations of capital gains tax issues.

There are roughly six hundred venture capital funds in the United States with about $30 billion under management. These funds are invested at a rate of about $4 billion per year in some 3,000 ventures, an average deal in excess of $1 million per firm. Contrast these figures with the following little known data. Our country's entrepreneurial ventures include about 50,000 high potential start-ups per year and 500,000 private companies growing at rates in excess of 20% per year, including 80,000 with annual growth rates in excess of 50%. The new equity financing required by these start-up and high growth ventures is in excess of $50 billion per year. Recent SBA sponsored research estimated the number of firms with informal (non-institutional) investors at 445,000 and the number of informal investors at 719,000. The study placed the annual value of informal equity investments at $32 billion. The SBA's data are not inconsistent with a 1986 Federal Reserve study of the financial characteristics of high income families. The prospect of substantial capital gains provides the incentive that motivates high risk, long-term investments in entrepreneurial ventures.

Private venture investors tend to be self-made high net worth individuals. According to TIME magazine: "An estimated 2 million U.S. men and women are millionaires, and nearly 90% of them earned their fortune by starting their own firm." In an article entitled "Ordinary Millionaires," U.S. NEWS & WORLD REPORT stated: "The typical millionaire is a self-made entrepreneur in his early 60's -- fewer than 10% are under 40. He works 10 or 12 hour days and, more frequently than not, his business caters to the ordinary needs of ordinary Americans." Self-made investors typically play an active role in building competitive enterprises by investing their know-how as well as their capital in the ventures they bankroll. High net worth individual investors (business angels) are one of our country's most potent and least understood economic resources.

In addition to scale differences, two other characteristics of angel financing need to be understood. First, compared to venture capital funds, private individuals are more likely to provide the relatively small amounts of ultra high risk seed financing required to launch new ventures, including those that subsequently attract professional venture capital. Second, private individuals are the primary source of later stage financing when the capital required is under $1 million. Financial histories collected from 284 new technology-based firms (NTBF's) by the Center for Venture Research illustrate both characteristics. The following tables are taken from the Center's study, "Equity Financing for New Technology-Based Firms."

ROUNDS INVESTED IN NTBF'S

Size of Round	Private Individuals		Venture Capital Funds	
<$250,000	102	(58%)	8	(5%)
$250,000-$499,999	43	(24%)	14	(8%)
$500,000-$999,999	15	(8%)	31	(18%)
≥ $1,000,000	17	(10%)	120	(69%)
Total	177	(100%)	173	(100%)

ROUNDS INVESTED IN NTBF'S

Stage	Private Individuals		Venture Capital Funds	
Seed	52	(29%)	11	(6%)
Start-up	55	(31%)	38	(22%)
First Stage	29	(16%)	56	(32%)
Second Stage	26	(15%)	46	(27%)
Third Stage	10	(6%)	19	(11%)
Bridge	5	(3%)	3	(2%)
Total	177	(100%)	173	(100%)

The study found that more new technology-based firms raised equity capital from unaffiliated individuals than from any other outside source, that private individuals were the primary source of funds when the size of the round was under $1 million, and that private individuals tend to invest earlier in the life of new technology-based firms than other sources of outside equity capital. It is important to note that private individuals provided the seed capital that launched the majority of firms in the sample.

In the interests of brevity, definitions of terms and citations for data have been omitted from this letter to the Committee. There are no directories of business angels and no public records of their venture investments. Nevertheless, appropriate documentation is available and will be provided promptly on request.

In the course of its deliberations, I urge the Congress not to overlook the central role of business angels in fueling our entrepreneurial economy. Whether the test is new jobs, new technology, or international trade, our country's entrepreneurs and venture capital markets represent our real competitive edge. Angels are essential players in this market -- and there are no tax exempt angels! Increasing the capital available to entrepreneurs is crucial if we are to regain our national competitiveness.

To paraphrase Pogo: **We have met the beneficiaries of capital gains tax reductions and they are all of us.**

Very truly yours,

William E. Wetzel, Jr.
Director
Forbes Professor of Management

WEW/sb